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British MPs' scandalous expenses

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Palaeolithic pornography

Three trillion dollars later...

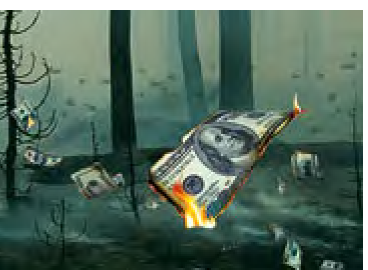
What have we learnt about how to run the banks?

AN 18-PAGE SPECIAL REPORT

Print edition May 16th 2009

Three trillion dollars later

There is no single big remedy for the banks' flaws. But better rules—and more capital—could help: leader



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Politics this week

May 14th 2009
From The Economist print edition

Barack Obama disappointed civil libertarians by reversing his promise to authorise the release of new photographs that have surfaced depicting American personnel allegedly **abusing prisoners** in Afghanistan and Iraq. The president now wants to block their publication because, he says, it could harm American troops. See article

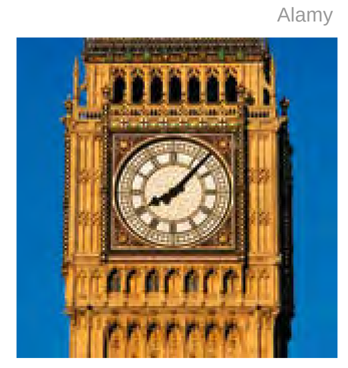
The United States was elected to the Geneva-based **Human Rights Council**, a 47-member UN body much criticised since its inception in 2006 (and ostracised by the Bush administration) for letting serial human-rights abusers set much of its agenda. Other newcomers were Belgium, Hungary, Kyrgyzstan and Norway.

The White House raised its estimate of the **budget deficit** for the current fiscal year to $1.84 trillion from the $1.75 trillion it forecast in February. Separately, an annual report projected that Medicare, the federal health-care programme for the elderly, would run out of cash by 2017 and that the Social Security trust fund would be empty by 2037. See article

Florida's moderate Republican governor, Charlie Crist, announced his intention to run for the Senate in 2010.

A time of reckoning

Alamy



A typically **British** orgy of revelation and recrimination followed the publication of expenses claimed over the past four years by members of Parliament. Several MPs and ministers volunteered, or were ordered, to repay their more outrageous claims. See article

John Demjanjuk, an alleged former Nazi death-camp guard, flew to **Germany** for trial after being extradited from America. Mr Demjanjuk, who is 89 years old, was tried and convicted in Israel 20 years ago, but his conviction was quashed after doubts were raised over his identity. See article

Italy's lower house backed a bill that would fine illegal immigrants and those who rent houses to them. The Italians have also introduced a policy of returning boatloads of migrants to Libya before any can claim asylum. Both moves were criticised by international agencies. See article

Ukraine's interior minister offered to resign after being detained by police at Frankfurt airport while apparently drunk. The Ukrainian government is already missing a foreign and a finance minister.

Swat team

Pakistan's army launched an offensive against Taliban militants in the Swat valley in North-West Frontier Province. Some 12,000 soldiers were pitted against an estimated 5,000 Taliban fighters. Hundreds of thousands of civilians fled the fighting. American officials praised the operation, which was also backed by Pakistan's National Assembly. See article

A UN spokesman in Colombo said that the "bloodbath" feared in the so-called "no-fire zone" in north-eastern **Sri Lanka** had become a reality. Hundreds of civilians were reported killed in shelling, as the army struggled to root out Tamil Tiger rebels from the last few square kilometres of land under their control. See article

The fifth and final round of **India's** election was completed, allowing the publication of the first exit polls. These suggested that no party had a majority and the government would again be a coalition.

Russia's prime minister, Vladimir Putin, visited **Japan** and signed an agreement on nuclear energy co-operation. He and Taro Aso, his Japanese counterpart, also promised to "study all options" to resolve the two countries' long-running territorial dispute over four islands.

Ichiro Ozawa, the leader of **Japan's** main opposition Democratic Party of Japan, resigned as a result of a fund-raising scandal in which a close aide has been charged. See article

Myanmar News Agency



Officials in **Myanmar** said that Aung San Suu Kyi, the detained leader of the opposition, would stand trial. The charges relate to an unsolicited visit by an American, who swam across the lake by her home where she has been held under house arrest.

North Korea said two American television reporters arrested near the Chinese border in March would be brought to trial in June for "hostile acts".

The national pastime

Venezuela's president, Hugo Chávez, ordered National Guard troops to seize the assets of private companies providing services to PDVSA, the state oil company. He said the state control of oil services was a "national security" issue. PDVSA owes its contractors some $14 billion and appears to have run short of cash. See article

In **Guatemala**, the government rejected a claim that it was behind the murder of a lawyer who left a video in which he said that the president, Álvaro Colom, would be responsible if anything happened to him. The lawyer was shot dead while cycling in Guatemala City. He represented a businessman who was murdered in April, he said for refusing a corrupt deal with the president.

In an election in British Columbia, in western **Canada**, the ruling Liberal Party was returned to power.

Office politics

South Africa's new president, Jacob Zuma, shifted Trevor Manuel, a fiscal conservative who has served as finance minister for 13 years, to head a new national planning commission, with undefined but apparently wide powers, in the president's office. The new finance minister will be Pravin Gordhan, a long-time communist turned social democrat who previously ran the tax-collecting department. See article

After heavy fighting in the Delta region in southern **Nigeria**, the main rebel group there told oil companies to evacuate their staff within 24 hours. The Movement for the Emancipation of the Niger Delta, known as MEND, said it had sunk two gunboats after coming under attack from the Nigerian armed forces.

Israel's prime minister, Binyamin Netanyahu, visited Egypt's president, Hosni Mubarak, before preparing to go to Washington for his first meeting, on May 17th, with Barack Obama at the White House since Mr Obama became president. It could be one of the trickiest meetings between an American and an Israeli leader, because Mr Netanyahu has yet to agree with Mr Obama's assertion that the Israeli-Palestinian conflict can be solved only by creating two states. See article

Getty Images

Pope Benedict XVI visited Jordan, Israel and the Palestinian territories. He failed to please his Israeli hosts who wanted more forceful language on the Holocaust. See article



Business this week

May 14th 2009
From The Economist print edition

It emerged that David Geffen, a music and film mogul, is interested in buying a large stake in the New York Times Company. As with others in the **newspaper industry**, the publisher of the Gray Lady is experimenting with business models and new technology to parry the demand for free news over the internet. Rupert Murdoch suggested recently that he might start charging users of the websites of titles owned by News Corporation, as he already does with the *Wall Street Journal*. See article

The muscle from Brussels

The European Commission's competition regulator fined **Intel** €1.06 billion ($1.44 billion), a European record and more than twice the amount it imposed on Microsoft in an antitrust ruling in 2004. The commission accuses Intel of paying illegal rebates to computer-makers to dissuade them from using chips made by Advanced Micro Devices, Intel's arch-rival. See article

EBay won an important victory in a French court, which found that it was not responsible for the sale of counterfeit items on its website. L'Oréal, a cosmetics company, brought the case, the latest in a series of European lawsuits over the past few years seeking damages against eBay for the sale of fake luxury goods.

Microsoft announced plans to offer its first-ever corporate bond. The company will raise $3.75 billion through the issue of long-term debt, adding to the already large pile of cash it keeps on hand.

BT's troubles came to the fore when it swung to a pre-tax loss of £1.3 billion ($1.9 billion) for the quarter ending on March 31st. The British telecoms company also cut its dividend and said 15,000 jobs would eventually be eliminated. BT took a charge of £1.3 billion at its global-services unit because of over-optimistic assumptions about the value of its contracts.

Verizon sold 4.8m telephone lines to **Frontier Communications** in an$8.6 billion deal that makes Frontier the biggest provider of telecoms services to America's rural areas.

Asset recovery

Bank of America raised $7.3 billion by selling a chunk of its stake in China Construction Bank. The money will go towards obtaining the $33.9 billion that, according to the recent official **stress tests**, BofA needs to guard against a severe downturn. Other banks requiring more capital include Wells Fargo ($13.7 billion), Citigroup ($5.5 billion) and Morgan Stanley ($1.8 billion).

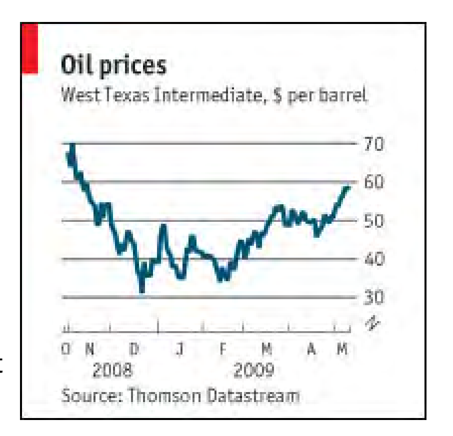
Tim Geithner, America's treasury secretary, unveiled a wide-ranging plan to regulate over-the-counter **derivatives**. In the run up to the credit crisis financial companies such as AIG took enormous risks in the derivatives market that went largely undetected.

Mervyn King, the governor of the Bank of England, took a contrary view to the recent bullish mood in the financial markets. He gave warning that conditions underpinning the outlook for growth in the **British economy** had worsened since February. See article

A.P. Moller-Maersk made a loss in the first quarter, the first at the shipper since at least the second world war. Other freight-line operators also reported losses. With the recession pressing down on shipping rates, about a tenth of the world's container fleet has been moored.

A rising tide?

The **price of oil** touched $60 a barrel. One factor behind the surge in prices, which have almost doubled since December, is strengthening demand for crude oil in China. Data showing that Chinese imports of copper and aluminium had increased helped push up the price of base metals, too.



The **unemployment** rate in the United States climbed to 8.9% in April, but the pace of lay-offs from payrolls slowed to 539,000, the fewest job losses since October.

As expected, **Sony** reported a net loss for the year ending March 31st, but forecast an even bigger loss this year as the slump in consumer demand hits sales of TVs and cameras.

More red ink was spilt at Japanese carmakers. **Nissan** reported its first annual net loss since Carlos Ghosn took charge in 1999; the company lost ¥233.7 billion ($2.3 billion) for the year to the end of March and gave a bleak outlook for the fiscal year. Earlier, **Toyota**, the world's biggest carmaker, posted its biggest-ever annual loss, of ¥437 billion.

Ford continued along its (non-government assisted) road to recovery by proposing a public share offering that could rake in around $2 billion. The money will probably go towards funding Ford's union health-care trust.

General Motors' share price fell to its lowest level since the Depression. The carmaker's stockmarket value is now around $700m, which represents less than 1% of Toyota's. Six senior executives at GM disclosed that they had sold all their remaining stock.

KAL's cartoon

May 14th 2009
From The Economist print edition

Illustration by KAL



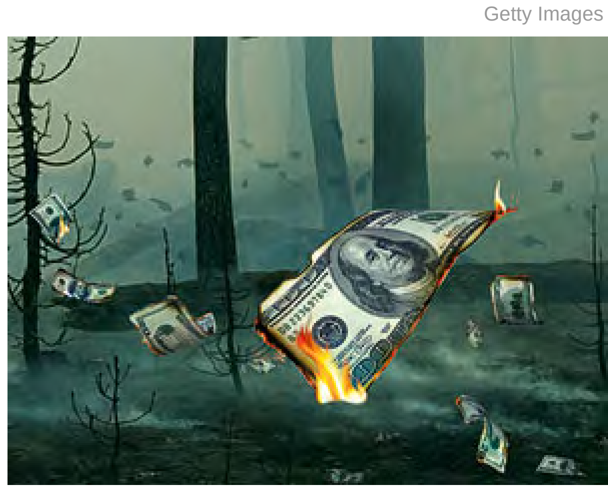
The banking industry

Three trillion dollars later...

May 14th 2009
From The Economist print edition

There is no single big remedy for the banks’ flaws. But better rules—and more capital—could help

Getty Images



COULD there be a better time to be a bank? If you have capital and courage, the markets are packed with opportunities—as they well understand at Goldman Sachs, which is once again filling its boots with risk. Governments are endorsing high leverage and guaranteeing huge parts of the financial system, so you get to keep the profits and palm off the losses on the taxpayer. The threat of nationalisation has receded, reinvigorating the banks’ share prices. Money is cheap, deposits plentiful and borrowers desperate, so new lending promises handsome margins. Back before the crash, banks’ profits just looked big; today they might even be real.

The bonanza is intentional. Governments and regulators want the banks to make profits so that they regain their health faster after roughly $3 trillion of write-downs. It is part of the monstrous bargain that bankers have extracted from the state (see our special report this week). Taxpayers have poured trillions of dollars into institutions that most never knew they were guaranteeing. In return, economies look as if they have been spared a collapse in payment systems and credit flows that would probably have caused a depression.

In an ideal world any government would vow that, next time, it will let the devil take the hindmost. But promises to leave finance to fail tomorrow are undermined by today’s vast rescue. Because the market has seen the state step in when the worst happens, it will again let financiers take on too much risk. Because taxpayers will be subsidising banks’ funding costs, they will also be subsidising the dividends of their shareholders and the bonuses of their staff.

It should be obvious by now that in banking and finance the twin evils of excessive risk and excessive reward can poison capitalism and ravage the economy. Yet the price of saving finance has been to create a system that is more vulnerable and more dangerous than ever before.

The great purge

Some argue that only draconian re-regulation can spare taxpayers from the next crisis. The structure must be changed. Governments should purge banks that are big enough to hold the system to ransom. Or they should seek to slice through the entanglements, cordoning off the dangerous bits. New “narrow”

banks would be guaranteed a seat in the lifeboat by the state and heavily regulated for the privilege. The rest of the industry would be free to swim—and to sink.

Yet this search for a big, structural answer runs into two problems. One is that the reform is not as neat as it first appears. Nobody wants to have banks that are so big that they stifle competition (itself a source of stability), but breaking big banks up into tiny bits that pose no systemic risk would be a horribly complex and lengthy task. As for narrow banks, precisely which bit is too important to fail? People's idea of a systemic risk can change quickly. Today's rescues have included investment banks and insurers, neither of which used to be regarded as system-threatening.

The second drawback is inefficiency. Limiting banks' size could stop them from attaining the scale and scope to finance global business. Confronted with restrictions, financiers innovate—in recent years, for instance, risk was shifted to non-banks such as money-market funds, which then needed rescuing. Regulators can stop innovation, some of which has indeed been abused, but Luddites in finance would do as much harm to the economy as Luddites in anything else.

Capital solution

Instead, it is better to focus on two more fiddly things that could produce fairly radical results: regulation and capital. By any measure, regulators need help. That help does not mean creating a new global authority to match the global scope of finance: the money for bail-outs ultimately comes from nation states. But there is plenty of sensible reorganisation to be done—America's system is a chaotic rivalry of conflicting fiefs, Britain's an ambiguous "tripartite" regime—and there is a useful general principle to enforce. Regulators should focus on function: if an outfit behaves like a bank, it should be regulated as one, whatever it says on the brass plate. Ideally each jurisdiction will incorporate a set of broad global principles, which establish a benchmark of prudent finance.

Regulators can also use markets. Banks' solvency depends on a bedrock of capital. Regulators could monitor how this trades, or use markets that gauge the risk of insolvency, to help decide when banks must raise more capital (see article). Regulators could get managers to watch for systemic risks by linking their bonuses to the bank's bonds. If managers identify with shareholders, as they do now, then they worry only about shareholders' losses. Catastrophic losses bigger than that are all the same to them. Incentives matter: with higher risk charges on banks' trading books, bankers would become more discerning about how they put their money to work, and less prone to make dangerous bets in pursuit of huge bonuses.

Smarter regulators and better rules would help. But sadly, as the crisis has brutally shown, regulators are fallible. In time, financiers tend to gain the advantage over their overseers. They are better paid, better qualified and more influential than the regulators. Legislators are easily seduced by booms and lobbies. Voters are ignorant of and bored by regulation. The more a financial system depends on the wisdom of regulators, the more likely it is to fail catastrophically.

Hence the overwhelming importance of capital. Banks should be forced to fund themselves with a lot more equity and other risk capital—possibly using bonds that automatically convert to equity when trouble strikes. Higher capital requirements would put more of the shareholders' money at risk and, crucially, enable banks to absorb more losses in bad times. Think of it as a margin for regulatory error.

Regulation cannot prevent financial crises altogether, but it can minimise the devastation. Loading banks with equity slows the creation of credit, but the reward for a healthy financial system is faster growth over the long term. There are three trillion reasons to think that the trade-off is worth it.

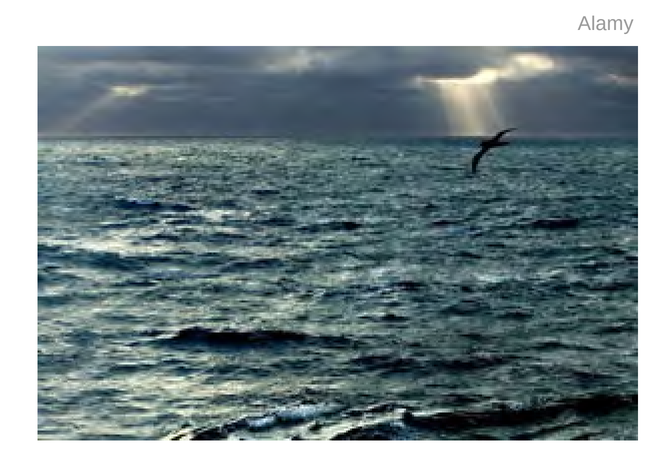
The sea

An awkward absence

May 14th 2009
From The Economist print edition

America is missing out by being stand-offish towards the law of the sea. So is the sea

Alamy



YOU do not see many milestones on the floor of the ocean, but one was passed this week. May 13th was the deadline for the submission of new claims to the seabed, and from pole to pole coastal states have been asserting ownership of vast chunks of continental shelf in a rush for territory unrivalled since the scramble for Africa at the end of the 19th century (see article). The treasure this time is not ivory or cocoa beans but petroleum, or at least the promise of it, and perhaps amazing fuels and wonder drugs, as well as gold, silver and other minerals. The claims will now be accepted or rejected by a United Nations commission, but one big maritime power will, by choice, be absent: the United States. It should not be.

Unlike 156 other countries, America has never ratified the 27-year-old UN Convention on the Law of the Sea, under which this carve-up is taking place. That is no worse than unfortunate: the deadline applies only to states that acceded to the treaty more than ten years ago and America still has time to make its claims. But first it will have to ratify the treaty. This the Obama administration, like its two most recent predecessors, wants to do, as probably does most of the Senate, which must provide its advice and consent. A determined minority, however, wants to block it, and finding the time for the necessary procedure may prove difficult.

America's original objections to the treaty related to the requirement that its companies should share technical information with poor countries. The treaty was changed to meet those complaints. Now the objectors say it would lead to a loss of sovereignty. In fact it would do the opposite, since it would allow America to claim sovereign rights over both the exclusive economic zone that extends 200 nautical miles (370km) from its shores and also its share of the continental shelf beyond that, so long as certain geophysical criteria were satisfied.

The treaty does other useful things. It provides the right of passage by sea for all countries' armed forces, and for almost all shipping through other states' territorial waters if the passage is innocent. An absolute right of passage is given in international straits and certain archipelagoes, such as Indonesia. Such provisions can only benefit American national security.

And just as America needs the treaty, so the treaty needs America. The sea is badly in need of better management. It is overfished, chiefly, it is true, in coastal waters, but also in the great expanses that belong to no state. The sea is increasingly used as a rubbish bin, filled with poisons, plastics and other pollutants. Parts of it are infested with pirates. All of it is growing alarmingly acidic, as the carbon dioxide spewed out by modern activities finds its way into the briny. And much of the CO_2 that causes this problem derives from oil and gas made less scarce by the reserves now recoverable from below it.

Scope for slip-ups in the Arctic

Nowhere is this last paradox more apparent than in the Arctic, where global warming means melting ice, which in turn means easier access to huge quantities of petroleum, most of it offshore. At the same time the once-icy Arctic may be opening up to shipping through the North West Passage, bringing the possibility of collisions, oil spills and other environmental horrors in a particularly vulnerable part of the world. For the people—and animals—who live in the polar region, even the law-of-the-sea treaty, fashioned in an era unconcerned about global warming, may provide inadequate safeguards.

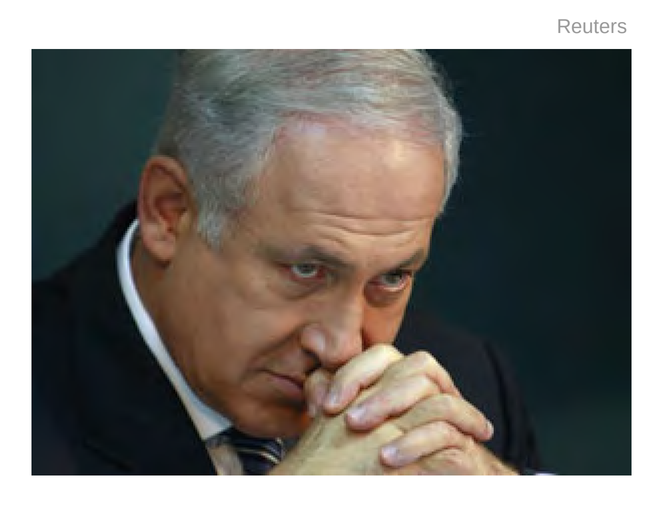
The treaty is certainly not going to solve all the troubles afflicting the oceans, nor settle all the world's maritime disputes. But it can help. To be effective, though, it needs America. Ratification has waited too long. The Senate should press ahead.

Don't hold back

May 14th 2009
From The Economist print edition

Barack Obama must not just scold Israel's leader but also promote his own plan soon

Reuters


FOR the first time in many years, an Israeli government is scared stiff that an American administration may squeeze it until its pips squeak. That is surely a good thing, if it makes the Israelis more amenable to giving the Palestinians the fair deal—in essence, a proper state of their own—that might bring peace to the two peoples and to the wider region of the Middle East. So when Barack Obama meets Binyamin Netanyahu in the White House on May 18th, he must be tough with him.

Mr Netanyahu refuses publicly to accept the notion of two states. He seems to want to continue to squeeze the Gaza Strip until its elected government, run by the Islamist movement, Hamas, is toppled. He says he will not give Syria back the Golan Heights, which Israel conquered in 1967. He now adds a demand that the Palestinians should not just recognise Israel as a country but as a specifically Jewish state. He refuses to freeze the growth of Jewish settlements that continue to bite into what is left of a barely contiguous Palestinian state on the West Bank. And, most pressingly, he seeks to link peace with the Palestinians to a prior deal between the West and Iran to ensure that the Islamic Republic is prevented from having a nuclear bomb. His stance on these issues makes him appear an unpromising partner in negotiation; but much the same was said of Menachem Begin, whom the Americans persuaded to make peace with Egypt 30 years ago, so it's certainly worth Mr Obama's while to put some political capital into budging him.

Mr Obama must tell Mr Netanyahu that he is flat wrong on all those counts. No more settlements can be built or expanded—on pain of a reduction in American aid. On Iran, Mr Netanyahu's logic is back-to-front. For sure, sensible leaders the world over, including Arab ones, want Iran to forgo the bomb. But how much easier it would be to persuade the Iranians to drop their ambitions if they were unable to invoke the unresolved conflict over Israel as part of a holy nuclear cause.

It is not just for the Palestinians' sake that Mr Obama needs to take a tough line. Being too kind to the Israelis, as American administrations have been in the past, does them no favour in the long run either. Israel's long-term security can be ensured only by America cajoling and even threatening its leaders in the hope that they will accept that the Israeli state's safety depends overwhelmingly on the viability of a Palestinian one.

Mr Netanyahu does, however, have one good question to pose to the American administration. Who would govern the Palestinian state the world wants him to create in the West Bank and Gaza? Mahmoud Abbas and his Fatah party run the West Bank under Israeli supervision but are chronically weak. Hamas is strong. Both movements say that Israel must withdraw from every inch of land occupied in 1967 and accept back to what is now the Jewish state all the Arab refugees who fled more than 60 years ago. But

unlike Fatah, which has explicitly accepted the idea of two states, Hamas, while groping towards a de facto acceptance of Israel, has yet to renounce its desire eventually to liberate all of Palestine from the Jordan river to the Mediterranean sea.

So far Mr Obama has held his cards to his chest. But if he is to push Israel into concessions he needs to answer the Hamas conundrum. Unlike George Bush's team, Mr Obama's has endorsed the idea of a Palestinian government that would include Hamas and so talk with more authority to the Israelis, making any agreement more likely to stick. The snag is that the two halves of the Palestinian movement are at daggers' drawn and have fluffed repeated opportunities to reconcile.

The chances are that Mr Netanyahu's rendezvous at the White House will not end in a public fracas. The Israeli leader is too clever for that, and shouting in public is not Mr Obama's style. More likely, the pair will frankly acknowledge differences. Mr Netanyahu is a practised opportunist—and may indeed edge towards an acceptance of the two-state idea over time. After all, he says he accepts Mr Bush's "road map" that led nowhere but clearly affirmed a two-state solution.

In Palestine it takes three to tango

Still, if the meeting does end in a stalemate, it will not be enough merely for Mr Obama to mutter doleful thoughts about reassessing America's special relations with Israel—and then back off. Former administrations told the Israelis and Palestinians that, in the end, it was for the two sides to negotiate peace. It is now plain that this approach does not work. America too needs to be deeply involved from start to finish.

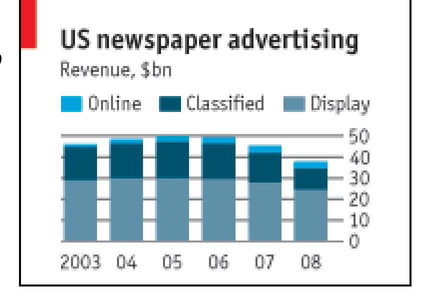
Jordan's King Abdullah, reasserting the Arab peace initiative of 2002, has boldly called for all Muslim governments to state clearly that they would accept Israel. They must make Hamas do so too. Next month Mr Obama goes to Egypt on his first presidential visit to an Arab country. That would be the perfect moment to unveil his detailed plan for peace, along with a promise that under his administration America intends at last to implement the two-state vision, not just talk about it.

Media

The rebirth of news

May 14th 2009
From The Economist print edition

The internet is killing newspapers and giving birth to a new sort of news business



THE race is crowded, but San Francisco stands a fair chance of becoming the first major American city without a daily newspaper. The *San Francisco Chronicle*, founded in 1865, is trimming its already pared-down staff in an attempt to avoid closure. And if it does disappear? "People under 30 won't even notice," says Gavin Newsom, the city's mayor.

Most industries are suffering at present, but few are doing as badly as the news business. Things are worst in America, where many papers used to enjoy comfortable local monopolies, but in Britain around 70 local papers have shut down since the beginning of 2008. Among the survivors, advertising is dwindling, editorial is thinning and journalists are being laid off. The crisis is most advanced in the Anglo-Saxon countries, but it is happening all over the rich world: the impact of the internet, exacerbated by the advertising slump, is killing the daily newspaper.

Does that matter? Technological change has destroyed all sorts of once-popular products, from the handloom to the Walkman, and the world has mostly been better for it. But news is not just a product: the press is the fourth estate, a pillar of the polity. Journalists investigate and criticise governments, thus helping voters decide whether to keep them or sack them. Autocracies can function perfectly well without news, but democracies cannot. Will the death of the daily newspaper—the main source of information for most educated people for at least the past century, the scourge of corrupt politicians, the conscience of nations—damage democracy?

Picked apart

A newspaper is a package of content—politics, sport, share prices, weather and so forth—which exists to attract eyeballs to advertisements. Unfortunately for newspapers, the internet is better at delivering some of that than paper is. It is easier to search through job and property listings on the web, so classified advertising and its associated revenue is migrating onto the internet. Some content, too, works better on the internet—news and share prices can be more frequently updated, weather can be more geographically specific—so readers are migrating too. The package is thus being picked apart.

The newspaper's decline is both cause and effect of the worrying finding by the Pew Centre that the number of Americans aged 18-24 who got any news at all the previous day has dropped from 34% to 25% over the past ten years. But that figure may be less troubling than it looks. Because newspapers pack together all sorts of different content, many of those who claimed in the past to have seen some news probably did so for a few seconds before turning the page to the sports scores. Acquaintance as shallow as that with the news is probably no great loss to society; Pew surveys of general knowledge suggest that young people are about as well (or badly) informed as they used to be.

And the newspaper companies' tribulations do not necessarily presage the demise of the news business, for they stem in part from the tumultuous and expensive transition from paper to electronic distribution. News organisations are currently bearing two sets of costs—those of printing and distributing their product for the old world, and providing digital versions for the new—even though they have yet to find a business model that works online.

Up to now, most have been offering their content free online, but that is unsustainable, because there isn't enough advertising revenue online to pay for it. So either the amount of news produced must shrink, or readers must pay more. Some publications, such as the *Financial Times* and the *Wall Street Journal*, which has more than 1m online subscribers and has just promised to develop a new system of

micropayments for articles, already charge for content. Others will follow: Rupert Murdoch, the *Journal*'s owner, has said he expects his other titles to start charging too. With news available free on Google and Yahoo!, readers may, of course, not be prepared to pay even for deeper or more specialised stuff; but since they do in the paper world, where free-sheets and paid-for publications coexist, there seems no reason why they wouldn't online.

Better mobile devices may encourage them to do so. Apple's iPhone is the first reader-friendly mobile phone, and the latest update to its software, due shortly, will enable news providers that currently give away content on the iPhone to start charging for it. Amazon has just unveiled a new, larger version of the Kindle, its e-book reader, better suited to displaying newspapers. Similar devices are available from other firms, with many more on the way. Better technology coupled with new payment systems will not solve the acute problems faced by newspapers today, but should eventually provide new models to enable news to flourish in the digital age.

And already, there are signs that it will (see article). New sources of news are proliferating online. Many, it is true, are unreliable. Most are badly funded. Some are the rantings of deranged extremists. But some—like *Muckety*, an American site which enriches news stories with interactive maps of the protagonists' networks of influence, and *NightJack*, the revealing and depressing blog of an anonymous British policeman, which won the Orwell prize last month—enhance society's understanding of itself, and could not have existed in the old world.

But the only certainty about the future of news is that it will be different from the past. It will no longer be dominated by a few big titles whose front pages determine the story of the day. Public opinion will, rather, be shaped by thousands of different voices, with as many different focuses and points of view. As a result, people will have less in common to chat about around the water-cooler. Those who are not interested in political or economic news will be less likely to come across it; but those who are will be better equipped to hold their rulers to account. Which is, after all, what society needs news for.

Parliamentary expenses

Moats and beams

May 14th 2009
From The Economist print edition

Cut back MPs' taxpayer-funded property profits; don't boost their pay

Illustration by Claudio Munoz



ACCORDING to the rules, MPs may recoup expenses that are incurred "wholly, exclusively and necessarily" in pursuit of their parliamentary duties. Britain's politicians have therefore had a difficult week, struggling to justify using taxpayers' money to buy black-glitter lavatory seats, clean swimming pools, clear moats and add fake Tudor beams to their houses. Leaders of the three main parties apologised for abuse of the expenses system. Chequebooks were remorsefully brandished, reforms promised and a poll showed that 85% of people think MPs are "self-serving and out of touch".

Britons usually take a dim view of their representatives and were never likely to turn out massively in next month's local and European elections, so it is hard to see this episode as a crisis of democracy. But an issue that has so infuriated the public does matter. These are troubled times, and the government is looked to for leadership. How can it crack down on tax evasion and benefit cheats, or muster support for cutting public services, if MPs themselves are seen to be on the take?

As the world goes, British politicians are not corrupt. But a sense of entitlement has grown up, and it is easy to see how: envy of university mates coining it in the City or medicine; coded bragging in the Commons bar about clever expenses coups; helpful show-you-the-ropes advice to new MPs; and a hotch-potch of murky allowances which governments have allowed to emerge as a substitute for pay increases they feared voters would object to. The most controversial is the right of non-London MPs to spend up to £24,000 ($36,000) a year on accommodation away from home (see article).

It's your fault, not the system's

This system was abused. It is not that people think out-of-town MPs should sleep in the streets, but they do grumble at providing them with the cleaning women and flat-screen televisions that many would love to be able to afford themselves. They resent seeing some MPs buy, do up and sell properties on the taxpayer's ticket (a heinous crime in a country where a man's home is not only his castle but his pension too).

Two things should now be done. The first is to punish the culprits. Ignore the excuses that "the system" was to blame. MPs made the rules. Some do not exploit them to the maximum. No one is forced to line his pockets. So heads should roll, led by the head of that system, the Speaker of the House of Commons, who has disgracefully treated the entire episode as an impertinent invasion of his privacy.

The harder task is to design a new system. There are three broad alternatives. The first is to ditch the second-home allowance and boost MPs' salaries by £25,000-30,000. This has the charm of simplicity, but it might prove a backhanded way of legitimising current dodges, such as trousering second-home money while dossing with family members. A second approach is to pay legislators a reasonable salary and provide accommodation, rent-free, for those who live far from the capital, as happens in Sweden. MPs who prefer their own lodging would receive a small subsidy, but nothing for furniture, refurbishment and the like. The boarding-school aspect of this solution might have a nostalgic appeal for some but is too regimented, perhaps, for the heirs of Magna Carta.

A third proposal, advanced by Britain's Liberal Democrats, is to give out-of-towners limited help in renting or buying a second home but to claw back any eventual gain (or loss) on the property. This would not be a blank cheque to finance lifestyle statements but would sensibly pay for the upkeep of property that essentially belongs to the taxpayer. This is an approach that Sir Christopher Kelly, in his independent report on parliamentary expenses due this year, could usefully endorse.

That leaves a more basic question: are MPs underpaid? At current exchange rates, British legislators get much less than their American counterparts, less than some Europeans and more than others. They earn less than bailed-out bankers, overpaid family doctors, civil servants running big departments or indeed some journalists. But their basic salary, at £64,766 a year, puts them in the top 4% of all employees; they get handouts of 50-100% of salary on leaving; and their pensions are cushier than the rest of the public sector's. There is no shortage of people who want to be MPs. Nor is it clear that brain surgeons would make a better fist of legislation than ordinary people with guts and common sense. MPs do not need a pay boost in excess of the formulaic annual uplift (2.3% this year) they get now. In 1931, when Britain's economy was performing much as it is now, MPs' pay was cut by 10%.

If Britain wants to attract a better class of MP, a more effective measure than larger salaries would be institutional reform. A stronger Parliament would mean a better, bigger job—and less time to spend fiddling expenses.

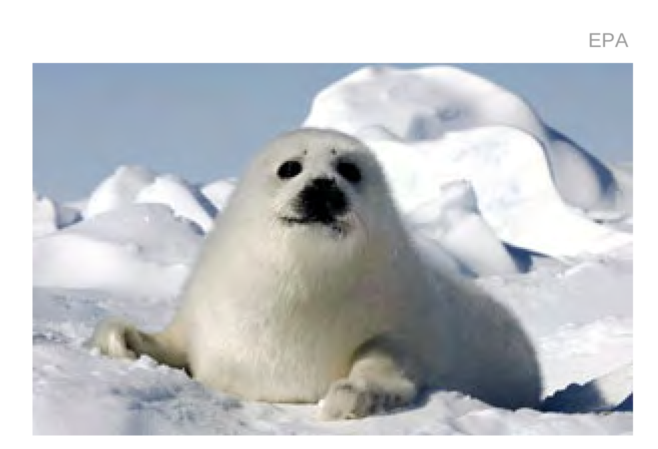
Seal hunting

Political animals

May 14th 2009
From The Economist print edition

European politicians are breathtakingly hypocritical about sealskins

EPA



ROUGHLY handled, and incompetently stunned, terrified animals may awaken several times before they are slaughtered. Some have their throats slit fully conscious. Europe's industrial farms dispatch 1m sheep, cattle and pigs every day. You cannot cater to the welfare of a large animal like a pig when the line must kill five in a minute.

If the European Parliament were really interested in animal welfare, then it might look rather more closely at the farming industry that the European Union so lavishly rewards with subsidies. But it has more pressing business. On May 5th MEPs, suddenly disgusted by the cruelty of people far away hunting seals, voted to endorse a ban on the trade of seal products, most of which come from Canada. Their hypocritical recommendation, which still has to be approved by the European Commission and Council, isn't even much good for the seals.

Bash it on the head, quick

Every year, 300,000 seals meet their end not by mauling from a polar bear, but instantaneously from gunshot or a blow from a club. Four years ago the WWF, an environmental organisation, commissioned an independent vet's report which concluded that seal clubbing is not cruel if it is properly done by competent and trained professionals. The report judged that the Canadian hunt was professional and highly regulated. And the vets said that popular horror of the seal hunt seemed to be based largely on emotion and on images that are difficult even for experienced observers to interpret.

By the grim standards of Europe's farrowing sheds, millions of seals enjoy a blissful life fishing and breeding on the Canadian ice. At least Canadian seals have the luxury of being stunned before they die. Compassion in World Farming, a lobby group, says that half the sheep killed in France are conscious when their throats are slit. Such treatment is possible through a loophole that allows for religious slaughter—a loophole that the same champions of animal welfare in the European Parliament voted to avoid closing on May 7th.

A few seals are killed to protect fish, others as a source of blubber or food. Most are indeed killed for their fur. That may not be to everyone's taste, but it is hardly unEuropean. Europe's fur farms produce over 30m mink and fox pelts a year. Every four or five days Europe kills more animals for their fur than the entire annual Canadian hunt does in a year. Seal hunting sounds unfair; but Europeans are reluctant to ban the hunting of similarly defenceless game birds, deer or wild boar.

A ban on the seal hunt would spare individual seals, but it may not do much for the seal population as a

whole. When wildlife cannot be traded, it loses its value and thus the incentive for people to conserve it. Today the hunters exploiting the seals have an excellent reason to maintain a healthy and growing population. A trade ban would mean that the management or maintenance of a wild population becomes just another drain on resources. Sometimes ecotourism pays the bills, but it works only in places that are easy for tourists to get to.

Why did the European Parliament overlook all this? Seal-murdering foreigners are a soft target and animal-welfare groups have been lobbying MEPs for years. It may not be a coincidence that they finally voted for a ban just a month before they face elections. Having been invisible to their constituents for the past five years, what better way for MEPs to save their own skins than to fight valiantly for those of baby seals?

On Jacob Zuma, Croatia, home ownership, Somali pirates, education, Greece, Machiavelli, economics

May 14th 2009
From The Economist print edition

First among equals

SIR – Your report on Jacob Zuma's victory in South Africa's general election rehashed old stereotypes that characterise Africa as a continent with a permanent propensity to descend into anarchy ("A big win for a new big man", May 2nd). South Africa is not ruled by a "big man" but by a collective of individuals who are democratically elected and who can be voted out of office at any time. In fact, it is the African National Congress that won the election and Mr Zuma must carry out the party's mandate.

If there is one lesson that the recent process demonstrated it is that to gain power in South Africa political parties must go out into communities to argue the case that they have the better agenda. Don't forget that it was the ANC government that built low-income housing and gave millions of people access to clean water and electricity. Yes, some people may be apprehensive about a political system dominated by a single party, but it is the job of opposition parties to offer superior alternatives. They still have a daunting task convincing the South African people that they can add substantial value to the country's politics.

Tshilidzi Marwala
Executive dean
Faculty of engineering and the built environment
University of Johannesburg
Johannesburg

Crime in Croatia

SIR – It appears to be no coincidence that your downbeat assessment of Croatia was published in the same week that the Foreign Office issued advice to British tourists about the danger from organised crime in that country ("A Balkan state in balk", April 18th). Both are a considerable exaggeration of the situation. It is true that some months ago there were two gangland-style killings in Zagreb, but the reason why the incidents "shocked public opinion" is that such killings are rare. In any event, such crimes, together with any corruption that may occur in Croatia, are arguably less common than in a number of existing European Union countries.

In addition, Slovenia's blockage of Croatia's EU entry negotiations is disgraceful. Firstly, when Slovenia was being considered for EU membership it said it had no border issues with its neighbours. Secondly, such unresolved bilateral issues are not supposed to be an obstacle to EU entry. If such a criterion had been generally applied, which of the existing member states would have been accepted?

Finally, if Croatia is in such a poor state morally and economically it may surprise your readers to learn that the *Banker* magazine named the current governor of the Croatian National Bank as "central banker of the year". This scarcely makes Croatia sound like a country that is out of control.

Aubrey Silberston
Professor emeritus of economics
Imperial College
London

For when you've Dunroamin

SIR – Your briefing on home ownership completely missed the point ("Shelter, or burden?", April 18th).

After you have paid off your mortgage you not only own the property, which becomes an asset, but your disposable income is substantially increased by not having to make monthly mortgage payments. This can be particularly beneficial in retirement, when income drops from salary to pension.

If you rent you pay for ever. You do not own the asset and when you retire you either have to cope with a significant drop in income or become a burden on the state.

Peter Kaye
Ramsey, Isle of Man

SIR – With pensions reduced because of the switch from defined benefit to defined contribution (for most outside the public service) some subsidy of home ownership is as justified as the subsidy to pension contributions. Those who want to play fast and loose with home loans, borrowing to the hilt, should not expect a subsidy. But as a means of retirement savings for those on modest incomes it does have a lot to recommend. Pension plans discourage blowing the lot on some bling to assuage a mid-life crisis. Subsidy towards home ownership needs similar rules.

Mark Scott
Redhill, Surrey

Pirates' militant links

SIR – It is claimed that Somali pirates attack ships "for gain rather than out of ideology" ("Perils of the sea", April 18th). This is not quite the full story. According to the East African Seafarers' Assistance Programme a group of jihadists in Somalia linked to al-Qaeda, Shabab, has been using earnings from piracy to support its activities onshore through the imposition of *sharia* law. This is not all that surprising. In a statement in April 2008 Shabab vowed to "throw the West into hell".

Aymenn Jawad
Cardiff

Education lesson

SIR – It says much for your integrity that your article calling for more choice and competition in education included a reference to the latest piece of research to reveal, like most previous studies, that there is no evidence that such a policy raises education standards ("Out the window", April 25th). Actually, what choice and competition really do is serve to increase social differentiation between schools. Schools seek pupils who will raise scores in raw league tables. Parents compete to get into the institutions that have been most successful in that endeavour.

The international evidence tells us that the most effective policy in raising standards is the rather boring long-term one of raising the quality of teaching and learning. Where this has been tried in Britain, as in the Success For All initiative in further education, it raised pass rates and retention spectacularly, before it was abandoned for another dose of choice and competition.

Adrian Perry
Senior visiting fellow
University of Sheffield
Sheffield

The following letter appears online only

Greek variations

SIR – May I make some observations about your article on Greece ("An Aegean fog", April 18th). The December 2008 riots to which you refer were prompted by the tragic killing of a 15-year-old student by a police officer. The government, the opposition and the Greek people all expressed their outrage and condemnation. The two police officers responsible have been brought to justice. Unfortunately, a few

hundred extremists hijacked the peaceful demonstrations and used violence to push their agenda of undermining the rule of law and democracy. Our democratic values compel us all to make the distinction between the freedom to demonstrate and the violent hijacking of this freedom. Please note that the presence of many young teenagers in the streets demonstrating in condemnation of the death of their fellow student led the police to adopt defensive tactics in order to avoid further bloodshed.

On the global economic crisis, Greece, like every other country, faces repercussions. In the middle of one of the deepest crises in history, however, Greece manages to retain the deficit relatively close to the 3% limit, while other European Union members have reached 8% or even 11%. The government applied a series of measures such as a public-sector wage freeze and spending cuts to secure the necessary financial discipline. The European Commission has pushed the deadline for reducing the deficit below 3% to the end of 2010. Repeated statements that Greece's place within the euro is firm and secure, as well as forecasts suggesting that Greece will be one of only five euro area countries with positive growth in 2009, are heartening.

As far as alleged scandals are concerned, due process is being followed in every particular case. The government is strongly committed to transparency and that every wrongdoing should be brought to light. This determination has resulted in more investigations and more wrongdoers being brought to justice than ever before. Today's dedication to transparency is the best strategy against corruption.

Finally, the information about two dead police officers in the April incident is inaccurate. No policeman was killed in the incident, but one was wounded.

Spyros Diamantis
Press counsellor
Embassy of Greece
London

The following letter appears online only

Philosophy 101

SIR –A reader stated that Niccolo Machiavelli thought it better for leaders to be loved than feared (Letters, May 9th). On the contrary, what Machiavelli actually said, in "The Prince", is that "It is far better to be feared than loved if you cannot be both," because "men worry less about doing an injury to one who makes himself loved than to one who makes himself feared."

Samuel Ottewill-Soulsby
Berlin

Economic dampening effect

SIR – You mentioned "subdued" business cycles and recessions in your briefing on central banks ("The monetary-policy maze", April 25th). For many decades, forest fires were suppressed by well-meaning officials. Fuel was allowed to build up, eventually resulting in far more devastating fires than would have occurred naturally. Today we allow fires to serve their necessary function, while limiting the damage to people and property.

Attempts to subdue the business cycle are much the same. Deadwood must be cleared out, inefficient practices curbed. The economy, like an ecology, is far more complex than we can comprehend.

Dave Lindbergh
Reading, Massachusetts

SIR – An enduring lesson of financial crises, you point out, is that "political constraints interfere with economically efficient solutions" ("The curse of politics", April 18th). But who is to blame that "academic economists often proposed solutions that glossed over real-world political and legal obstacles"? This is, once again, the proclivity of a profession that has long left the real world for mathematical niceties in ever more intricate models. I would thus propose an alternative title to your article: "the curse of economics."

Ranko Bon
Motovun, Croatia

Suddenly, a wider world below the waterline

May 14th 2009
From The Economist print edition

Coastal states have now made their bids for vast new areas of continental shelf

YOU never know what may come in handy. That is the principle behind the rush for the seabed that reached a climax of sorts this week with the deadline on May 13th for lodging claims to extensions of the continental shelf. When Russia sold Alaska to the United States for two cents an acre (five cents a hectare) in 1867, it thought it was parting with a useless lump of ice. After gold was discovered there, it began kicking itself. Now it is one of a host of countries eagerly laying claim to swathes of the seafloor that may one day yield huge riches. That is the hope anyway.



The rules for this carve-up derive from the 1982 United Nations Convention on the Law of the Sea. These gave all countries that had ratified the treaty before May 13th 1999 ten years in which to claim any extension of their continental shelf beyond the normal 200 nautical miles (370km), so long as that extension was no more than 100 miles from the point at which the sea reached a depth of 2.5km, and no more than 350 miles from land. Any other country wishing to make a claim has ten years from the date on which it ratified the treaty. It must then, like all the states that have now made their claims, submit copious scientific evidence to show that the seabed in question is indeed continental shelf.

If it passes all the tests, it can exploit the minerals on or under the seabed in this margin, so long as any revenue is shared with poorer and landlocked states. No new rights are given over fish or other creatures in the water column, but living creatures on or below the seafloor that are immobile "at the harvestable stage" are treated like minerals. Harvesting here is not entirely fanciful. Pharmaceutical companies are already mincing up marine creatures known as sea cucumbers that may yet provide drugs for treating cancer. Sea cucumbers can move, but other useful plants or animals may be stuck in the mud.

More beguiling perhaps are metal deposits (see article) and energy reserves. These include not just petroleum but also methane hydrates, white, sorbet-like compounds that exist in profusion under the sea, perhaps containing more energy in total than all known deposits of fossil fuels. They can often be found on the slopes of the continental shelf, though as yet they are impossibly awkward to extract. In the long run, however, they may prove valuable to countries like Japan and India with few energy sources on land.

For many countries, though, the first booty from any newly acquired seabed will be either oil or gas, both of which can now be extracted fairly easily from deep water. It was surely with this in mind that Russia, in 2001 the first country to submit a continental-shelf claim, made a bid to extend its rights in both the Pacific and the Arctic oceans. Six years later a Russian submersible was to plant a titanium flag on the seabed 4km below the North Pole.

Since the Russian application, 49 others have followed, some making multiple claims in several places, some submitted jointly by several countries in one area. Some countries have also made more than one submission. Thus Britain, France, Ireland and Spain have jointly made a claim in the Celtic sea and the Bay of Biscay. Britain has made a second in respect of Ascension island in the South Atlantic, a third concerning the Hatton-Rockall area in the North Atlantic and a fourth concerning the Falklands, South Georgia and the South Sandwich islands in the South Atlantic.

All of this last area is also claimed by Argentina, which went to war with Britain in 1982 over the Falklands. It will now be hotly contested again. Argentina's latest claim, moreover, appears to include land and sea right down to the South Pole, to judge by the map filed with its submission.

This is not the only place in which two countries have competing designs. China and South Korea are at odds over a part of the East China sea. And China has submitted a map that seems to assert ownership of a vast part of the South China sea. This includes much more than the Spratlys, an island group long claimed by Malaysia, the Philippines and Taiwan too. China objected within hours to Vietnam's Spratlys claim on May 7th.

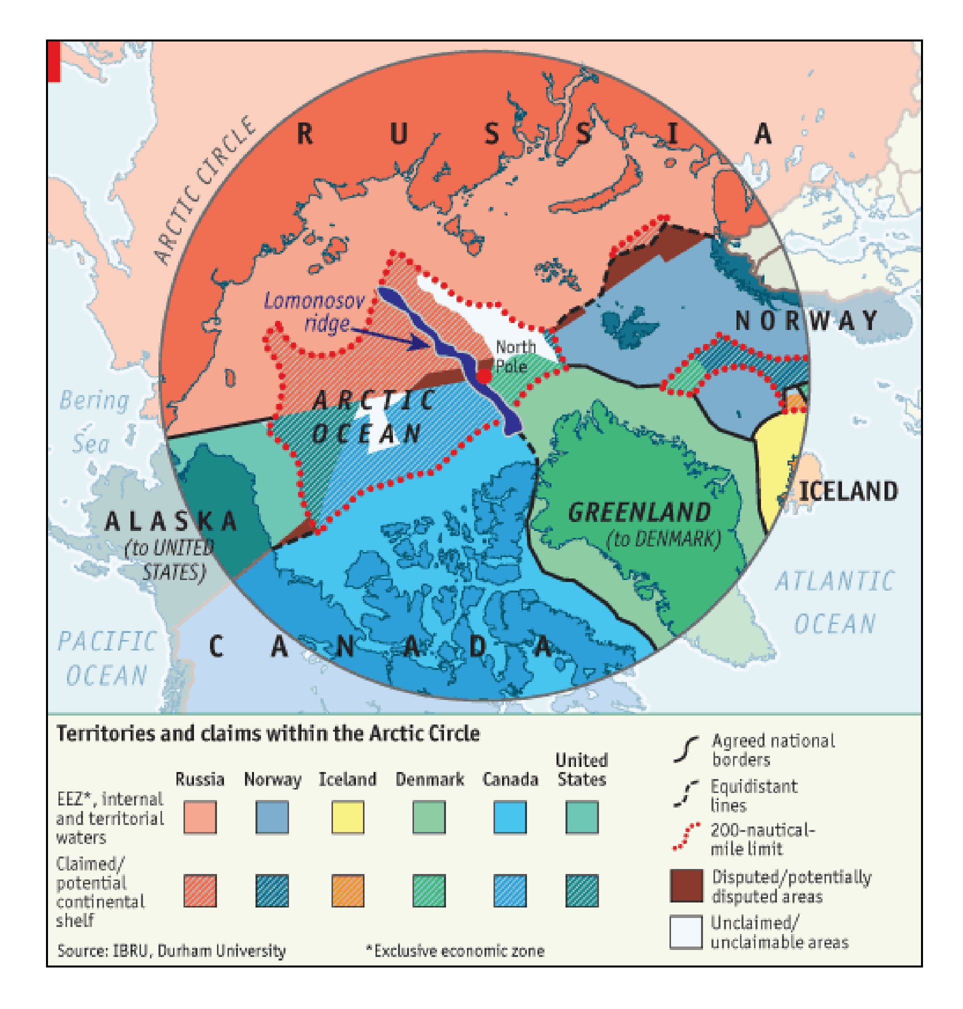
Trouble is also brewing in the Indian ocean. Tanzania and the Seychelles look like falling out over an area near Aldabra, and Mauritius has claimed an area round Rodrigues island that includes the Chagos archipelago. This is regarded by Britain as part of its Indian Ocean Territory. It includes Diego Garcia, whose people, all removed in the 1970s so that the island could be used as an American base, last year lost a legal appeal to be allowed home.

Another old imperial power, France, is also hoping to make the most of its residual colonies, and in doing so is antagonising friends. Its clash is with Canada, and concerns St Pierre & Miquelon, a group of tiny islands little more than 25km from Newfoundland that front onto a shelf blessed with oil deposits. They belong to France.

Canada did not ratify the law-of-the-sea treaty until 2003, so has no need to submit its claims until 2013. Denmark likewise has until 2014, and the United States has no deadline since it has not ratified the treaty (see article). These are three of the five countries that border on the richest, and trickiest, prize of all, the Arctic (Denmark because it owns Greenland, unless and until the Greenlanders should become independent, as some wish). All five states have ambitions for more Arctic seabed.

Most of the Arctic is continental shelf, so most of it will eventually be allotted to one of the five neighbours (Iceland also has a small claim within the Arctic Circle). But since it has been largely covered with year-round ice throughout modern history, it is the least mapped ocean. Claims are therefore specially hard to substantiate.

The Arctic is rich in oil and gas. Indeed, some people think it holds nearly a quarter of the world's undiscovered reserves. Though Russia put in an early four-part bid under the treaty, the part concerning the Arctic has in effect been shelved. So the only submission under active consideration is Norway's. Each of the other Arctic neighbours, however, is busy mapping and preparing the data needed for claims already made public (see map below).



Clashes are plain between Canada and the United States, and between Russia and Norway. And Canada, Denmark and Russia are each likely to make individual bids for the North Pole. Even so, there is a lot of co-operation among the competitors. Canada and Denmark, for instance, are working together to try to show that the Lomonosov ridge, which cuts across the Arctic and is the basis of Russia's claim for the pole, extends to their territories.

Similar co-operation has taken place among countries in other parts of the world. Most coastal states that knew a claim would be contested have made agreements that one would not object to a neighbour's bid if the other showed reciprocal forbearance. Many of the joint submissions will be followed by further deal-making among the states concerned.

Formally, all states now have three months in which to make protests. In reality, they have much longer. Some of the submissions are not firm, merely "indicative" bids that will serve as holding operations. Even now the Commission on the Limits of the Continental Shelf, the body that considers the claims, is in danger of being overwhelmed. It must rule on everything from the geophysical (is the sedimentary composition correct?) to the metaphysical (what's the difference between a rock and an island?). A month ago it had given full consideration and approval to only five of the 22 claims lodged. Since then another 28 have followed.

The commission will encourage states to settle squabbles by negotiation. If they fail, they can go to the International Court of Justice in The Hague, or to a special tribunal in Hamburg. But too much should not be made of the disputation. The most remarkable feature of the seabed scramble is that it gives the potential of huge economic gains to some of the world's smallest and poorest countries—coastal states in Africa, island nations in the Pacific, poor places like Barbados, Suriname and Yemen, none of them usually seen as sophisticated maritime powers. If they are now lucky enough to gain new rights over oil or minerals, they may soon be able to exploit them. Neptune should be smiling.

Seabed mining

The unplumbed riches of the deep

May 14th 2009 | WOODS HOLE, MASSACHUSETTS
From The Economist print edition

And why they'll wait a while longer before being disturbed



IN TEENSPEAK, if a star such as Madonna or J.Lo is huge, that is a reference not to her size but to her popularity. Similarly, in the world of seabed geology, if a sulphide deposit is massive, it is not necessarily big, but formless and rich in metals. As it happens, seafloor massive sulphides are also huge—at least they were until recently. The collapse in commodity prices last year has diminished them a bit, but many expect their popularity to recover.

The excitement arose because oceanographers had started to find these mineral-rich deposits on the network of submerged mountain ranges that run along the seabed between continents (see map). Such ridges occur where the great plates of the Earth's crust are spreading apart, and the seafloor holds formations of hot, volcanic rock.

Ever since the dredges of *HMS Challenger* on her voyage of scientific discovery in the 1870s brought up from the depths "immense numbers of more or less circular nodules", it has been known that lots of minerals lie on the seabed. However, most of these plum-sized objects—known as manganese nodules, though they contain several other metals—are several kilometres deep. Russia mines some in territorial waters in the Gulf of Finland and several other countries hold exploration licences, but bringing them to the surface has never become economic.

In the 1960s, however, mineral deposits of a different kind were found in the Red Sea, where the spreading seafloor impels the slow separation of Africa and Arabia. A similar stretching takes place wherever two tectonic plates move apart, for example, in the Galápagos Rift off Ecuador, and it was here in 1977 that the first deep-sea hydrothermal vents were discovered. These vents form above cracks in volcanic areas of the ocean floor through which seawater seeps, there to be heated by hot, sometimes molten rock. The water dissolves minerals deep in the Earth's crust before rising like a geyser from the seafloor at temperatures of up to 400°C.

This mineral-laden fluid, if it is rich in iron and sulphur, emerges to create a plume of black "smoke", from which, when it meets cold bottom water, the minerals are precipitated. Tall chimneys form, growing up to six metres (20 feet) a year, and around them live strange creatures: giant tubeworms, for instance, with neither mouth nor stomach nor anus, that live on microbes whose energy derives not from the sun but from chemical compounds in the fluids from the crust. Over time the chimneys collapse, creating the deposits of high-grade massive sulphides that so excite the deep-

sea miners.

Hydrothermal vents of this kind are found roughly every 100km (54 nautical miles) along the 65,000km or so of mid-ocean ridge. They are also found in volcanic “back-arc” basins behind ocean trenches, where one tectonic plate is sliding beneath another. Many of these basins are in the western Pacific, part of a great “ring of fire” that runs in a horseshoe from New Zealand north through Indonesia, the Philippines and Japan, eastward through the Aleutian islands and then south along the Pacific coast of North and South America, encompassing most of the world’s active and dormant volcanoes.

High-grade stuff, just sitting there

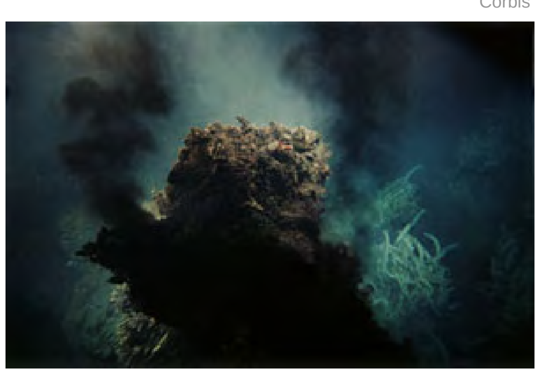
One reason massive-sulphide formations beguile miners is that the metals they contain—notably copper, gold, zinc and silver—are highly concentrated. Another is that they are often big, 200 metres wide and long, tens of metres thick, and may contain several million tonnes of ore. All lie on the surface of the seabed, and many are only 1-2km below water level.

At that depth technology developed for the offshore oil industry can nowadays be employed for mining. In particular, the deep-water pumps and suction pipes developed to bring subsea oil up to the surface can be used in the riser pipes needed to bring minerals (mixed with water) up from a massive-sulphide mine. The oil industry has also developed remotely-operated vehicles to make trenches for seabed pipelines, which can be adapted for cutting ore, even though it may lie much deeper, at, say, 1.5km down. In general the technology in the machines needed to carry out deep-water mining is no longer exotic. Woods Hole Oceanographic Institution has a vehicle that can reach depths of 11km.

Apart from the Russians, the only company mining the seabed at present is De Beers, which gathers diamonds off the coasts of Namibia and South Africa. These gem-quality stones were once carried down the Orange river and have since been swept up the coast, some even borne ashore by tide and wind. But they lie only about 100 metres down, so scooping them up is fairly simple.

Two other companies have shown serious interest in seabed mining. One is Neptune Minerals, an Australian-based company that applied for a mining licence in 2008 for two deposits in about 1,250 metres of water near the Kermadec islands off New Zealand. It has also been granted exploration licences in territorial waters off Papua New Guinea, the Federated States of Micronesia and Vanuatu. But it is nowhere near mining commercially. The other company is Nautilus Minerals, a Canadian firm whose Solwara 1 project in Papua New Guinea’s territorial waters contains 60,000-100,000 tonnes of copper, and gold too. It was due to start production next year, but most operations are now on hold.

Corbis



Smoke without fire—just copper, zinc, gold and silver, and creatures unimaginable

The big mining companies have been watching these two ventures with interest. Anglo American, one of the biggest, has an 11% holding in Nautilus (and 45% in De Beers), chiefly, it says, to keep abreast of the possibilities of seabed mining. But Chris Carlon of Anglo is emphatic that the world’s mining industry is not yet eager to tackle the deep ocean. For a start, there is a glut of copper, the metal that probably has to cover the cost of any massive-sulphide mine, leaving gold or some other more valuable metal to provide the profit. Last year the industry produced 360,000 tonnes of copper that turned out to be unwanted. Second, plenty of land-based deposits still remain to be exploited. Anglo American alone produces on land as much copper as the likely output of 100 massive-sulphide mines. As for gold, a tonne of old mobile phones contains about three times as much of it as a tonne of typical ore, even though recovery may be problematic.

Moreover, mining companies much prefer the known difficulties of operating on land to those of operating on the seabed. The risks of working in a place where volcanic activity seems to have stopped but may suddenly resume are uncertain. So indeed are the possible obligations to repair the underwater environment: no legal codes are yet in place for deep-sea mining. That helps to explain why the only places in which companies have dipped more than a toe in the water are in exclusive economic zones, which are not just shallower than many parts of the distant ocean but also within the legal ambit of a national authority.

Seafloor mining beyond countries’ territorial waters is regulated by the International Seabed Authority, set up under the United Nations Convention on the Law of the Sea. So far it has issued only eight licences, all for exploration, not

production, all for nodules, not massive-sulphide deposits, and all to governmental or quasi-governmental agencies (of China, France, Germany, India, Japan, Russia, South Korea and an east European consortium). No wonder. Commercial miners want both a clear title to their holding and exclusive rights to exploit it. They also have to answer to shareholders.

One day, however, deep-sea mining will surely start to look commercially attractive again. At present China and Russia are the two countries most interested in massive sulphides, followed by India and South Korea. Russia, which has been grubbing around on the seabed for years, knows exactly what it wants and where: it has found four massive-sulphide deposits of over 10m tonnes each in the past four years, all on the Mid-Atlantic Ridge. China is less sure of what it is after, but has become interested in the southern Indian Ocean, as well as the zone in the North Pacific where most of the manganese-nodule licences have been granted. While China makes up its mind, it is blocking all decision-making at the International Seabed Authority, which was due to issue legal, environmental and revenue-sharing regulations about mining in international waters this month but is unlikely to do so. Fortunately, no miners are in a hurry to get started—and massive sulphides, unlike huge rock stars, can wait.

California

The ungovernable state

May 14th 2009 | LOS ANGELES, SACRAMENTO AND SAN FRANCISCO
From The Economist print edition

As California ceases to function like a sensible state, a new constitution looks both necessary and likely



ON MAY 19th Californians will go to the polls to vote on six ballot measures that are as important as they are confusing. If these measures fail, America's biggest state will enter a full-blown financial crisis that will require excruciating cuts in public services. If the measures succeed, the crisis will be only a little less acute. Recent polls suggest that voters are planning to vote most of them down.

The occasion has thus become an ugly summary of all that is wrong with California's governance, and that list is long. This special election, the sixth in 36 years, came about because the state's elected politicians once again—for the system virtually assures as much—could not agree on a budget in time and had to cobble together a compromise in February to fill a $42 billion gap between revenue and spending. But that compromise required extending some temporary taxes, shifting spending around and borrowing against future lottery profits. These are among the steps that voters must now approve, thanks to California's brand of direct democracy, which is unique in extent, complexity and misuse.

A good outcome is no longer possible. California now has the worst bond rating among the 50 states. Income-tax receipts are coming in far below expectations. On May 11th Arnold Schwarzenegger, the governor, sent a letter to the legislature warning it that, by his latest estimates, the state will face a budget gap of $15.4 billion if the ballot measures pass, $21.3 billion if they fail. Prisoners will have to be released, firefighters fired, and other services cut or eliminated. One way or the other, on May 20th Californians will have to begin discussing how to fix their broken state.

California has a unique combination of features which, individually, are shared by other states but collectively cause dysfunction. These begin with the requirement that any budget pass both houses of the legislature with a two-thirds majority. Two other states, Rhode Island and Arkansas, have such a law. But California, where taxation and budgets are determined separately, also requires two-thirds majorities

for any tax increase. Twelve other states demand this. Only California, however, has both requirements.

If its representative democracy functioned well, that might not be so debilitating. But it does not. Only a minority of Californians bother to vote, and those voters tend to be older, whiter and richer than the state's younger, browner and poorer population, says Steven Hill at the New America Foundation, a think-tank that is analysing the options for reform.

Those voters, moreover, have over time "self-sorted" themselves into highly partisan districts: loony left in Berkeley or Santa Monica, for instance; rabid right in Orange County or parts of the Central Valley. Politicians have done the rest by gerrymandering bizarre boundaries around their supporters. The result is that elections are won during the Republican or Democratic primaries, rather than in run-offs between the two parties. This makes for a state legislature full of mad-eyed extremists in a state that otherwise has surprising numbers of reasonable citizens.

And that is why sensible and timely budgets have become almost impossible, says Jim Wunderman, president of the Bay Area Council, an association of corporate bosses. Because the Republicans are in a minority in the legislature, they have no sway until budget time, when they suddenly hold veto power thanks to the two-thirds requirement. Because in the primaries they have run on extremist platforms against other Republicans, they have no incentive to be pragmatic or moderate, and tend simply to balk.

What was unusual about this year's deadlock was only its "record lateness", says Mr Wunderman, which amounted to an "anti-stimulus" that negated much of the economic-recovery plan coming from Washington, DC. "No real conversation is possible on anything that matters," he says, whether it be California's fraught water supply, its barbaric prison conditions or its teetering public education.

Representative democracy is only one half of California's peculiar governance system. The other half, direct democracy, fails just as badly. California is one of 24 states that allow referendums, recalls and voter initiatives. But it is the only state that does not allow its legislature to override successful initiatives (called "propositions") and has no sunset clauses that let them expire. It also uses initiatives far more, and more irresponsibly, than any other state.

Direct democracy in America originated, largely in the Western states, during the Populist and then Progressive eras of the late 19th and early 20th century. It came to California in 1911, when Governor Hiram Johnson introduced it. At first, it made sense. The Southern Pacific Railroad dominated politics, society and the courts in the young frontier state, and direct democracy would be a welcome check and balance. The state in 1910 had only 2.4m residents, and 95% of them were white. (Today it has about 37m residents, and less than half are white.) A small, homogenous and informed electorate was to make sparing and disciplined use of the ballot to keep the legislature honest, rather as in Switzerland.

Citizen-power gone mad

Sparing and disciplined it stayed until the 1970s. But then came a decade of polarisation and voter mistrust. In 1978 Californians sparked a nationwide "tax revolt" by passing Proposition 13, which drastically limited property taxes and placed a permanent straitjacket on state revenues. That launched an entire industry of signature-gatherers and marketing strategists that now puts an average of ten initiatives a year on the ballot, as Mark Baldassare, the boss of the non-partisan Public Policy Institute of California, has calculated. In 2003 direct democracy reached a new zenith—or nadir, some might say—when Californians "recalled" their elected and sitting governor, Gray Davis, and replaced him with Mr Schwarzenegger.

Saving the state

California's special-election ballot measures

Proposition	Summary	Budgetary impact	Public support
1A	Creates a rainy-day fund by limiting future spending, extends temporary taxes	None immediately, smooths future budgets	👎
1B	Guarantees future education funding, but only if 1A passes as well	Some savings now, costs in future budgets	👎
1C	Lets state borrow against future lottery profits, market lottery sales	Big & immediate: $5 billion	👎
1D	Shifts revenues from child-development programmes to general fund	Some savings	👎
1E	Shifts revenues from mental-health programmes to general fund	Some savings	👎
1F	Freezes legislators' pay during budget deficit years	Negligible	👍

Sources: California secretary of state; *The Economist*

The minority of eligible Californians who vote not only send extremists to Sacramento, but also circumscribe what those representatives can do by deciding many policies directly. It is the voters who decide, for instance, to limit legislators' terms in office, to mandate prison terms for criminals, to withdraw benefits from undocumented immigrants, to spend money on trains or sewers, or to let Indian tribes run casinos.

Through such "ballot-box budgeting", a large share of the state's revenues is spoken for before budget negotiations even begin. "The voters get mad when they vote to spend a ton of money and the legislature can't then find the money," says Jean Ross of the California Budget Project, a research outfit in Sacramento. Indeed, voters being mad is the one constant; the only proposition that appears certain to pass on May 19th would punish legislators with pay freezes in budget-deficit years.

More than half of the initiatives don't pass, and some that do are sensible. But much of the system has been perverted into the opposite of what Hiram Johnson intended. It is not ordinary citizens but rich tycoons from Hollywood or Silicon Valley, or special interests such as unions for prison guards, teachers or nurses, that bankroll most initiatives onto the ballots.

Then comes a barrage of television commercials, junk mail and robo-calls that leave no Californian home unmolested and the great majority confused. Propositions tend to be badly worded, with double negatives that leave some voters thinking they voted for something when they really voted against. One eloquent English teacher in Los Angeles recently called a radio show complaining that, after extensive study, she could not understand the ballot measures on grounds of syntax.

The broken budget mechanism and the twin failures in California's representative and direct democracy are enough to guarantee dysfunction. The sheer complexity of the state exacerbates it. Peter Schrag, the author of "California: America's High-Stakes Experiment", has counted about 7,000 overlapping jurisdictions, from counties and cities to school and water districts, fire and park commissions, utility and mosquito-abatement boards, many with their own elected officials. The surprise is that anything works at all.

As a result, there is now a consensus among the political elite that California's governance is "fundamentally broken" and that the state is "ungovernable, unless we make tough choices", as Antonio Villaraigosa, the mayor of Los Angeles and a likely candidate for governor next year, puts it. What are those choices?

Incremental reform, says one set of analysts. Darrell Steinberg, a thoughtful Democrat who is the current leader of the state Senate, says that the dysfunction is often overstated, since the system was deliberately designed "to ensure that change occurs slowly". He believes that several piecemeal reforms already slated will fix most of the problem.

So does California Forward, a bipartisan think-tank supported by several of the state's *éminences grises*. A change to districting rules should end gerrymandering, starting next year. And there is talk of open primaries in which people vote irrespective of their party affiliation, and then elect a candidate in a run-off between the top two vote-getters, whether from the same party or not. Together, these two steps would make the state's representative politics more moderate, says James Mayer, California Forward's director. Representatives should also have longer terms in office, he thinks, to reduce the permanent

turnover that pits greenhorn legislators against savvy and entrenched lobbyists.

Founding fathers wanted

Many others, however, now believe that California needs to start from scratch, with a fully-fledged constitutional convention. California's current constitution rivals India's and Alabama's for being the longest and most convoluted in the world, and is several times longer than America's. It has been amended or revised more than 500 times and now, with the cumulative dross of past voter initiatives incorporated, is a document that assures chaos.

Calls for a new constitution have resurfaced throughout the past century, but never went far. That changed last August, as the budget negotiations were once again going off the rails, when Mr Wunderman of the Bay Area Council renewed the call for a convention and received an astonishing outpouring of support. Mr Schwarzenegger has called a constitutional convention "a brilliant idea" and thinks it is "the right way to go". (The new constitution would take effect well after he leaves office.) Most encouragingly, says Mr Wunderman, nobody, not even the so-called special interests, has yet come out against a convention.



To the extent that there is scepticism at all, it is not about the idea of a new and cleaner constitution but about the process that might lead to it. If a convention set out to rewrite the entire constitution, it would end in the usual war over hot-button social issues such as gay marriage or the perennial Californian fight over water. And there is concern that "the nutwings are the ones who will show up, not the soccer moms," as Ms Ross of the California Budget Project puts it. The same partisan extremists bickering about the same controversies would lead nowhere.

To address these concerns, the Bay Area Council, which has become the driving force behind the scheme, has put forth two ideas. First, delegates to the convention should be chosen through the general jury pool to ensure that the whole population, as opposed to partisans or voters, is represented. Second, the scope of the constitutional convention would be explicitly limited to governance issues and the budget mechanism and would exclude all others.

This should enable reform in the most vital and interconnected areas. These are: reducing the two-thirds requirement for budgets and taxes; mandating two-year as opposed to annual budgets; giving local governments more access to local revenues; creating less partisan districts and primary elections; disciplining the process of direct democracy with new rules about signature collection; and introducing a "sunset" commission, as Texas has, that would gradually retire overlapping jurisdictions and offices to achieve something more manageable.

The plan is to introduce voter initiatives in next year's ballot calling for a constitutional convention, to have the convention the following year, and to put the new constitution on a ballot in 2012, when it would take effect. In the meantime both the incrementalists, such as California Forward, and the wholesale reformers, such as the Bay Area Council, are backing the propositions on next week's ballot. Even if they succeed, this would only temporarily reduce the urgency for radical reform; failure would cause intolerable pain.

The federal budget

Phoney war

May 14th 2009 | WASHINGTON, DC
From The Economist print edition

The real battle, over health care, is just beginning

THE first hundred days were busy, Barack Obama noted, but the pace would be just as hectic in the second hundred: they would be spent building “a library dedicated to my first hundred days”. The president delivered the joke at the White House press corps’ annual shindig, but it makes an apt metaphor for the past week. He and his officials have released a blizzard of tax and health-care proposals that largely repackage, or add detail to, the ambitious draft budget he released in February.

That draft sought to extend health insurance to the millions of Americans who lack it, cut taxes for the majority of workers and spend more on education and energy research. To pay for it, Mr Obama would raise taxes on the rich and on corporations, cut wasteful programmes and auction off permits to emit carbon dioxide.

Alamy



Old and costly

That agenda has since hit several road blocks. The president’s budget proposed limiting the deductions wealthy taxpayers can take for, among other things, charitable contributions. After an uproar from charities, Congress signalled it would not go along. Mr Obama called for cutting agricultural subsidies for richer farmers. Farm-state legislators rejected that, too. Mr Obama would like to raise $210 billion from companies with foreign operations, by such means as limiting the deferral of tax on income earned overseas. Senior senators in both parties fret that this would drive American firms overseas.

Mr Obama has taken flak for talking about sacrifice but not asking for any. On May 7th he responded by listing $17 billion in cuts to programmes deemed inefficient or wasteful, from the F-22 fighter jet to jailing immigrant criminals. True, it was a pittance next to a budget deficit already soaring towards $2 trillion and 12% of GDP, a post-war record. But Mr Obama’s budget director, Peter Orszag, argued that wasteful spending encourages broader fiscal laxity just as broken windows encourage criminality. “We can no longer afford broken-window budgeting,” he said. Many in Congress, however, seem happy to leave the windows broken, and rushed to defend the threatened programmes.

Most problematic of all, prospects for a cap-and-trade bill this year have deteriorated. Mr Obama wants to auction off, rather than give away, permits to emit carbon dioxide. But a bill that could allow that, sponsored by Henry Waxman and Ed Markey, senior Democrats on the House Energy and Commerce Committee, is solidly opposed by Republicans and by many Democrats in coal- and oil-producing states. This suggests that the bill has little chance of becoming law this year, robbing Mr Obama of funds he planned to use to make his workers’ tax cut permanent.

These setbacks should not be read as defeat, however. In the coming months, Congress and the administration are likely to hammer out compromises on many disputed items. Democrats in Congress will be under pressure to deliver at least $17 billion of discretionary spending cuts, even if they are not the ones Mr Obama requested, because they have passed a budget resolution requiring even larger cuts.

Moreover, the real test for Mr Obama is health care, and there momentum appears to be on his side. This week health-care-industry officials promised, at his urging, to cut cost-inflation by 1.5 percentage points a year, or $2 trillion over ten years. The promise was largely meaningless: if $2 trillion in savings was lying around, a profit-maximising industry would have found them. And it remains dead-set against Mr Obama’s wish for a public insurance plan that competes with private ones. But the event had symbolic importance. Jim Horney, of the liberal Centre on Budget and Policy Priorities, says it shows the industry will not try to kill this health reform as it killed Bill Clinton’s attempt in 1994.

If Mr Obama's health-care ambitions fail, cost will probably be the reason. Mr Obama insists that his reform should be paid for rather than add to the budget deficit, so his budget earmarks $634 billion in cuts to existing health programmes and various tax increases. But that is unlikely to be enough to pay for a plan that would cover most uninsured Americans.

Passing the tax increases necessary to pay for expanded health care will be hard if the economy remains weak, and the more so because that will also mean a bigger deficit. Mr Orszag has already raised his budget-deficit estimates by $200 billion over the next three years, largely because the economy is generating less tax revenue per dollar of output than previously thought. The deficits would be even bigger if he used a more pessimistic, and therefore realistic, economic forecast.

Meanwhile, the threat to America's long-term fiscal health is growing. On May 12th the administration released updated figures on the health of the Social Security and Medicare programmes for the retired. The recession has slashed payroll-tax revenue, which means that the future, unfunded cost of the programmes has increased. It now exceeds $104 trillion, or 8% of future GDP, compared with 7.6% last year. People are also living longer, which adds to the costs. Mr Orszag, never slow to press a point, wrote on his blog that this "should reinforce all our efforts to get health reform done this year."



Man and man in Maine

May 14th 2009 | BEDFORD, NEW HAMPSHIRE AND PORTLAND, MAINE
From The Economist print edition

Same-sex marriage laws have swept New England. Other states will follow

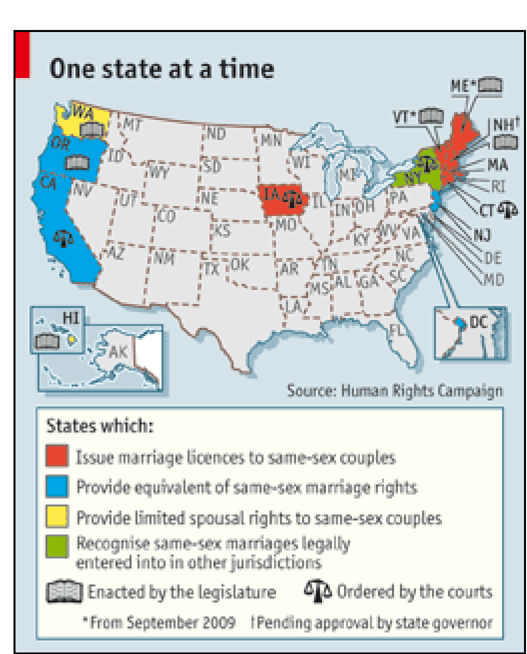
“IF MY dad married a man, who would be my mom?” asks a golden-haired child in an ad from the National Organisation for Marriage, a group that campaigns to keep wedlock heterosexual. “I’m confused,” adds another adorable moppet.

Ethan Mondor, however, is not confused. Now nine years old, he was plucked from foster care at the age of four and adopted by two gay men, Rodney Mondor and Ray Dumont. They are both his daddies. But if one of them has to be mom, it would be Ray. Rodney does daddyish things such as helping to coach Ethan’s little-league baseball team. Ray plays flamboyant parts in amateur theatricals. He also plays the “mommy” role at home by doing most of the worrying, he says.

Families like Ray and Rodney’s are becoming boringly normal. Last week the legislatures in both Maine and New Hampshire passed bills recognising same-sex marriage. In Maine, Governor John Baldacci immediately signed the bill into law. In New Hampshire, Governor John Lynch was still pondering what to do as *The Economist* went to press.

New England is now a hotbed of equality. In 2003 Massachusetts became the first American state to legalise gay marriage. Connecticut followed suit last year, and Vermont last month. If Mr Lynch declines to wield his veto, five out of six states in New England will have allowed gay marriage in less time than it took to dig a tunnel under Boston. Only Rhode Island, a tiny state with a large Catholic population, shows no sign of permitting it.

In all, a dozen states now recognise gay unions in some way (see map). California, New Jersey and Oregon allow civil unions that are marriages in all but name. Hawaii and Washington state allow gay couples some of the legal benefits of marriage. New York and Washington, DC recognise gay marriages performed in other jurisdictions and may soon decide to perform their own.



Even more encouraging for gay activists, politicians in liberal states are discovering that they can cast gay-friendly votes without being punished for it on polling day. Seven state legislatures have now voted to allow gay marriage or some watered-down variant of it. This marks a significant change. The first states to allow gay marriage did so by court order: unelected judges suddenly announced that laws limiting marriage to straight couples were unconstitutional. This struck many Americans as undemocratic and helped fuel a furious backlash. In 2006 alone, anti-gay-marriage ballot initiatives passed in seven out of eight states where they were put to a vote. In California, a court order allowing gay marriage was overturned by a referendum last year. Laws passed by elected lawmakers may be harder to reverse.

Not that social conservatives won’t try. In Maine they hope to gather more than 55,000 signatures in 90 days, thus forcing a referendum on whether to re-ban gay marriage. But advocates of gay marriage have the wind at their backs. Most Americans support either gay marriage or gay civil unions. And according to Gallup, the proportion of Americans who think gay marriage should be legal has risen to 40% from 27% in the mid-1990s.

Although public opinion has not shifted much in the past couple of years,

Reuters

gays can expect to add to their gains. Young Americans are much more laid-back than their elders: those aged 18-34 are twice as likely to support gay marriage as those over 65. They are also twice as likely to have a close gay friend or family member. Familiarity breeds tolerance, which makes it easier for gays to come out. Conservatives cannot break this circle.



All legal in Connecticut

For one thing, their arguments are rather abstract. They say that gay marriage undermines the traditional sort, but have trouble explaining how. They say that traditional marriage provides an excellent environment for raising children, which is true. But when people meet doting gay parents such as Ray and Rodney, they find it hard to argue that their son would be better off in a foster home. Kevin Smith, a family-values campaigner in New Hampshire, worries that when gay marriage is legal, children will be taught in schools that it is acceptable. An increasing number of Americans would reply: So what?

Gay marriage is likely to continue spreading from state to state. At the federal level, however, it faces higher hurdles. Gays expect nothing from Republican administrations and are taken for granted by Democratic ones. Bill Clinton signed the Defence of Marriage Act, which barred federal recognition of gay marriage. So even where gay couples enjoy all the legal benefits of marriage under state law, they do not enjoy equality under federal law.

Barack Obama says he supports civil unions but, as a Christian, opposes gay marriage. The incoherence of this stance makes it conveniently difficult to attack. Mr Obama has promised to repeal the Defence of Marriage Act and to let gays serve openly in the armed forces. But he has made no effort to do either.

That said, most gay Americans above a certain age have only to dip into their memories for proof that their country has grown dramatically more tolerant. Terry Guerette, a lesbian from a religious family in Maine, remembers her late father saying that all “queers” should be shot. Her relatives all embrace her now, she says.

Prisoner abuse, continued

Bad publicity

May 14th 2009 | WASHINGTON, DC
From The Economist print edition

Barack Obama seeks to keep secrets

LAST month the Pentagon agreed to release 44 photos showing Americans allegedly abusing prisoners in Iraq and Afghanistan. This week, President Barack Obama objected. The photos were to have been released by May 28th, after the American Civil Liberties Union (ACLU) and others filed a freedom-of-information suit and won. But Mr Obama, who had previously agreed with the ACLU, now wants to keep them secret.

His change of heart follows protests by military commanders, who argue that publishing such photos will endanger American lives. Terrorists used the photos of abuse at Abu Ghraib prison in Baghdad—which showed prisoners stacked in naked heaps and menaced by dogs—as a recruiting tool. The commanders worry that the new photos would be used for the same purpose just as the spring fighting season gets under way in Afghanistan.

The ACLU retorts that the photos should be made public because they "provide visual proof that prisoner abuse by US personnel was not aberrational but widespread." The Pentagon disagrees. The photos were collected as part of an investigation into alleged abuses that took place between 2003 and 2006. Those found to have mistreated prisoners—at least 400 people—were punished. Mr Obama has decided that putting more ghastly images onto the internet "would only serve the purpose of inflaming the theatres of war."

Mr Obama continues to disappoint those among his supporters who see no trade-off between national security and civil liberties. Earlier this month, officials floated the idea of reviving George Bush's military commissions to try terrorist suspects. Mr Obama is also reluctant to prosecute Mr Bush's lawyers for arguing that waterboarding was not torture, and therefore allowable. Democratic activists are desperate to put Bushites in the dock. But the party's leaders are conflicted, not least because some of them knew exactly how information was obtained from important terrorist suspects.

New Orleans

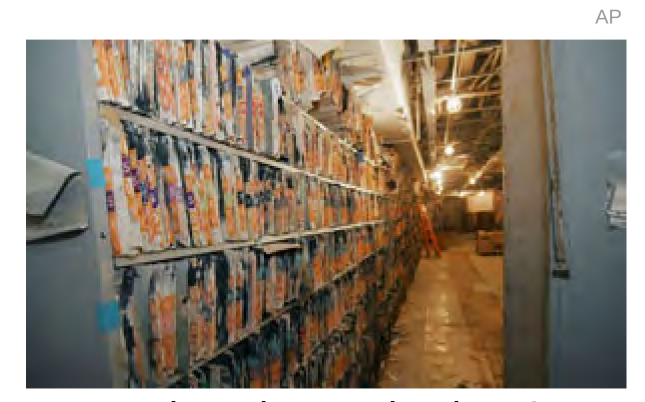
City of sickness

May 14th 2009 | NEW ORLEANS
From The Economist print edition

Medical services have not recovered from the storm

HURRICANE KATRINA'S effect on the city of New Orleans has been much longer-lasting than most expected. Almost four years after the storm, a quarter of the population has never returned. A third of homes still lie empty, many decked with tarpaulins and with the flood-line still visible. Residential streets are lined with houses with collapsing porches, fallen plasterwork and hopeful For Sale signs. Less than half the city's public transport facilities have been restored, and the wheels on the city's famous street-cars, even the one named Desire, are still rusty.

AP



Your records may be somewhere here. Or not

Most important, though the number of chronically sick in the city has risen sharply, medical services remain in tatters. Only 57% of the city's medical facilities have reopened, and tens of thousands of records have been lost. In St Bernard Parish, which once had two hospitals, there is now none. Charity Hospital, the main refuge for the poor and uninsured for more than 250 years, is shuttered and surrounded by wire fencing. Doctors, nurses and military personnel spent a month cleaning and decontaminating the first three floors in the weeks after Katrina, but the hospital remains closed. Last month a group of citizens launched a legal appeal for it to be reopened, claiming that corrupt officials are using it as an excuse to get access to federal relief funds. But the owners of the building want to sell it.

The Lindy Boggs Medical Centre became a symbol of the struggle for survival in the hot, dank days after the flood. A day after the levees broke, the generators in the hospital failed, knocking out ventilators, transfusion machines and fresh water supplies. Nineteen patients died. The hospital is now to become a shopping centre.

Even in hospitals that are functioning again, medical staff are in short supply and treatment has become riskier. Emergency-room medics complain of having to treat too many desperately ill patients simultaneously. This increases the chance of both mistakes and lawsuits. That fear has led some doctors who live in the city to commute to hospitals far outside New Orleans rather than work locally.

Even before the storm, Louisiana was the least healthy state in America. In the past few years, however, levels of sickness have risen sharply. Almost two-thirds of New Orleans residents now report chronic health problems, a 45% rise since 2006. The percentage of people suffering from mental difficulties, mostly depression, has tripled since then, and the suicide rate has doubled since 2005. For months thousands of people were housed in temporary trailers which were poorly ventilated and contained high levels of formaldehyde. In the houses which were left habitable, mould and spores grew during the many humid weeks when the city lacked electricity. As a result, respiratory and skin problems are rife.

Greater poverty is also a factor. Almost a fifth of New Orleans households now live below the federal poverty line ($22,000 a year for a family of four). Many people were unemployed for months after

Katrina and, although the number out of work has fallen, the effects endure. An estimated 12,000 people are still homeless.

The situation is expected to deteriorate in the coming years. Nearly 20% of people are now without health insurance. One in four say the emergency room is their primary source of care and, as the recession bites, that proportion is growing. Plans for two new hospitals are mired in payment battles and preservation disputes, meaning neither will become operational until at least 2013. It is little wonder that one in five New Orleans residents say they are considering leaving.

Lexington

How to fix a party

May 14th 2009
From The Economist print edition

The Republicans could learn a lot from the Democrats

Illustration by KAL



THE Grand Old Party is getting less grand by the day. It failed to return a single congressman from New England in 2008. Republicanism is about as popular as celibacy among 18-30-year-olds. A recent *Wall Street Journal*-NBC poll revealed that in the party's heartland, the South, there are more self-identified Democrats than Republicans.

So far the party has shown few signs that it knows how to reverse its slide into irrelevance. Should Republicans shout louder? Apologise for recent mistakes? Launch a listening tour? The only thing that the party's various factions seem to have in common is an obsession with junk food. Jeb Bush, the former governor of Florida, launched his "listening tour" in a pizza joint. Mark Sanford, governor of South Carolina and one of the party's most outspoken traditionalists, argues that Chick-fil-A would never allow its franchisees to cook their chicken any way they like; so why should the Republican Party allow its elected officials to promote big government?

Here is a modest suggestion for the Republicans: why not learn from the Democratic Party? The Democrats have had much more experience of defeat than the Republicans. They saw a two-to-one advantage in party identification in 1952 disappear by 2002. They were locked out of the White House for 20 of the 28 years between 1980 and 2008. As recently as 2003 a Democratic senator from Georgia, Zell Miller, denounced his party as "a national party no more". But today the Democrats are contemplating power without end.

The first lesson from the Democrats is to create a "vital centre"—one that is a source of ideas rather than split-the-difference compromises. The Democratic Leadership Council (DLC) has been challenging old-fashioned liberalism since 1985. DLC-affiliated politicians have been designing centrist ideas in conservative America for almost as long: Kathleen Sebelius, Barack Obama's health secretary, Janet Napolitano, the head of his Department of Homeland Security, and Hillary Clinton, his secretary of state, cut their political teeth in Kansas, Arizona and Arkansas respectively. At the same time, Mr Obama has made a huge fuss about embracing anybody and everybody.

The Republicans are showing some signs that they understand the importance of the centre ground. They are cooing about their success in recruiting Charlie Crist, Florida's middle-of-the-road governor, to run for the Senate, for example. But the Republican centre is very far from being vital. Most centrist politicians

are opportunists rather than policy innovators. The party's leading think-tanks are all on the right. The first priority should be to create a Republican version of the DLC, to act as a counterbalance to Washington's conservative establishment and an inspiration to innovative Republicans across the country.

The second lesson is the importance of detoxifying the party. The Democrats have realised that you cannot win elections as long as your party is associated with toxic people or un-American causes. Bill Clinton, the detoxifier in chief, denounced Sister Souljah, an extreme rap artist, signed welfare reform into law, balanced the budget and cut 350,000 people from the ranks of government. More recently, the party has chosen strategic silence on the vexed question of gun rights.

Again, a few Republicans show signs of understanding this strategy. They have tried distancing themselves from Rush Limbaugh and his kind, issued increasingly abject apologies for following George Bush wherever he led, and generally promised to be a nicer bunch. But that is only a start. They need to follow through on their Sister Souljah moments rather than issuing abject apologies whenever Mr Limbaugh cracks the whip. They need to abandon their state of denial about global warming. And they need to recognise that gay marriage could well be their equivalent of the gun issue. The party's opposition to gay marriage not only makes them look mean-spirited. It is also destroying any chance Republicans have of regaining the support of younger Americans. Gay marriage is becoming progressively more popular among young Americans at a time when another favourite conservative issue, abortion, is of less concern to them.

Competence tests

The third lesson is the importance of proving that you can run a country. Jimmy Carter destroyed the Democratic Party for a generation because voters concluded that both he and his party were too incompetent to be trusted with the White House. George Bush may have done the same thing for the Republican Party. He turned a surplus into a gigantic deficit. He launched the war in Iraq on the basis of false intelligence and wildly optimistic assumptions about how easy it would be to win. He filled important government posts with klutzes who were appointed on the basis of family loyalty and ideological litmus tests. By the final months of his presidency, Americans judged Democrats to be more competent than Republicans by a margin of five to three.

Regaining their reputation for competence is the most difficult task Republicans face. It is also the most important. The party's current strategy is to argue that Mr Obama is too soft on America's enemies and too loose with the purse-strings. But this is hardly likely to reassure people who associate Republicanism with military adventurism and hypocritical spending.

The Republicans need to demonstrate that they understand the importance of self-restraint, both at home and abroad. They need to prove that they are more interested in solving practical problems than in ticking ideological boxes. This suggests that the party's revival is likely to start in the same place as the Democratic Party's revival—among the ranks of post-ideological governors out there in purple America.

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Presidential re-election in Colombia

Uribe edges towards autocracy

May 14th 2009 | BOGOTÁ
From The Economist print edition

A popular president seems to be heading towards a third term, despite the damage this would do to democracy

Reuters



ONCE a country with a healthy, even exaggerated, distrust of executive power, Colombia is on the brink of allowing Álvaro Uribe to seek an unprecedented third consecutive term as president. The Senate is due to vote on May 19th on a bill to call a referendum on the required change in the constitution. Once the text is reconciled with a version already approved by the lower house, it would be reviewed by the Constitutional Court, and could be put to the people in November. Mr Uribe has still not said whether he intends to run in the election due in May 2010, but he has done nothing to discourage the idea. If he is a candidate, on present trends he would win. But some influential Colombians—and outsiders—believe a third term would be a huge mistake for both Mr Uribe and his country.

Many Colombians credit Mr Uribe with transforming their homeland from a near-failed state to a buoyant, if still violent, place. Their gratitude won him a second term in 2006, after the constitution was changed to allow a second consecutive term. After seven years in office, he still enjoys an approval rating of 71%, according to Invamer-Gallup, a pollster. In a poll this month, 59% said they would turn out for a referendum; of those, 84% said they would back Mr Uribe's right to run again.

The president has said that his overriding concern is the continuation of his "democratic security" policies, which have curbed violence, weakened leftist guerrillas and demobilised many right-wing paramilitaries. But in the same breath he suggested that he alone can ensure that this progress will continue: "Perpetuating oneself in the presidency troubles me, but I cannot be politically irresponsible," he declared.

Some of those who oppose a third term have been among Mr Uribe's closest aides. They include Fabio Echeverri, who ran both his presidential campaigns. There is some hesitation among government legislators: the Senate vote was postponed this week, though the main stumbling block involved demands for political favours.

"No to re-election", declared *Semana*, Colombia's leading newsweekly (which has generally been critical of the president), on its cover this week. Its main argument was that the checks and balances in the constitution are designed for a four-year presidential term and that an erosion of the separation of powers under Mr Uribe would be aggravated by a third term.

Such worries are all the greater because Mr Uribe’s rule has not been free of abuses and scandals. These include the army murdering innocent civilians and disguising their corpses as guerrillas killed in combat. This prompted the government to sack 30 officers last October, including three generals. So far 22 soldiers, including three colonels, have been arrested over these crimes. The United Nations High Commissioner for Human Rights last year complained of “widespread and systematic” killings of civilians by the army. Prosecutors at the attorney-general’s office are investigating 1,296 such allegations since 2002.

The government insists that it is committed to ending and punishing such abuses, which it says are isolated. But its allies abroad seem to be becoming more sceptical. Mr Uribe enjoyed a close friendship with George Bush. The Democrats who control the American Congress have held up ratification of a free-trade agreement with Colombia, ostensibly because of worries about the killings of trade unionists. In March Britain announced that it was ending a scheme under which it trained Colombian soldiers in human rights (though it is maintaining counter-drug aid and giving money to civic groups and the judiciary). David Miliband, the foreign secretary, expressed concern that “there are officers and soldiers of the Colombian armed forces who have been involved in, or allowed, abuses.”

Another running sore involves the civilian intelligence service, known as DAS. Three successive directors of this body, each chosen by Mr Uribe, are being questioned by prosecutors over claims that DAS illegally spied on opposition politicians, journalists and Supreme Court justices. On May 8th the first of the three, Jorge Noguera, was charged with conspiracy and murder. He is accused of colluding with paramilitaries and helping to plan the murders of an academic, a journalist, a union leader and a politician.

Mr Uribe will shortly have the chance to propose a new attorney-general, who critics worry may be less zealous than Mario Iguarán, the incumbent. In a third term, the president could fill the Constitutional Court with his nominees. Senior judicial appointments must be ratified by Congress, but the president has enjoyed a comfortable legislative majority.

A second argument wielded by opponents of a third term is that national priorities have changed. Polls find that the economy tops security as a public concern. That is partly a tribute to Mr Uribe’s success, and partly a consequence of gathering recession. Third, Mr Uribe risks aggravating a worrying regional trend. In Venezuela, Hugo Chávez recently won a referendum abolishing term limits and followed it up by harassing opponents.

Assuming that Mr Uribe is not simply bluffing, and that his supporters in the Senate do not have second thoughts, would he really win? A deteriorating economy is probably the biggest threat to a third term. But Michael Shifter of the Inter-American Dialogue, a Washington think-tank, says that because he is seen as a “crisis president”, this could even help him.

There are other strong candidates. Juan Manuel Santos, the defence minister, is expected to resign soon in order to run, though he says he would not do so against Mr Uribe. Another contender is Sergio Fajardo, an independent who was a reforming mayor of Medellín, Colombia’s second city. If he doesn’t quit while he is still ahead, history may judge that Mr Uribe began to undo his own achievement.

Venezuela's oil industry

Skint

May 14th 2009 | CARACAS
From The Economist print edition

Expropriating accounts payable

EPA



The gas-injection will come from Hugo

UNTIL a few weeks ago, the Venezuelan government was encouraging private investment in oil services. But in a sudden about-turn, President Hugo Chávez changed the law to make the whole industry a preserve of the state. On May 8th the National Guard began to occupy dozens of drilling rigs, docks and boats operated by private contractors, both local and foreign, hired by PDVSA, the state oil company.

Mr Chávez invoked national security. PDVSA complains that the oil-services firms did not cut their prices when the oil price plummeted last year. But the real reason seems to be that PDVSA has run out of cash. At the end of last year it owed contractors $14 billion, according to a report to the National Assembly.

Mr Chávez says that PDVSA will save $700m a year by ending the outsourcing of activities ranging from docks to maintenance and to the pressurised gas and water injection that many Venezuelan oil wells require. But there will be a cost, and not just in lost technology.

The constitution sets prior judicial review and “fair compensation” as conditions for expropriation. But the oil-service firms will get only the book value of their assets, paid in government bonds and with deductions for any labour or environmental liabilities the government adduces. Many of the service contracts allow for international arbitration, so PDVSA is likely to face expensive lawsuits. And other service contractors not yet taken over may scale back their investment in Venezuela.

Despite years of record oil revenues, PDVSA accumulated liabilities of almost $70 billion by last September, up from less than $30 billion in 2006, according to the company’s financial reports. The company is itself owed more than $24 billion, mostly by Cuba and other neighbours to whom Mr Chávez supplies oil on easy terms.

PDVSA’s decline stems in part from the fact that Mr Chávez has turned what was an efficient oil company into an all-purpose vehicle for implementing “21st-century socialism”. PDVSA, whose workforce has more than doubled since 2003, now builds houses, imports food, runs farms and pays for adult-education projects.

The government insists that Venezuela continues to produce over 3m barrels per day (b/d) of oil. Independent sources put the figure at around 2.2m b/d. The government’s main hope of boosting output lies in the Orinoco heavy-oil belt. It has been seeking foreign partners for the big long-term investment required. Already the adjudication of seven new blocks has twice been postponed. “PDVSA is demanding bidders renounce arbitration rights,” says Pedro Palma, an economist. “Given what has happened, that could be suicidal.”

The cash crunch in the oil industry has a wider impact. “We don’t supply PDVSA directly,” says the owner of a small office-supplies company in the eastern city of Maturín. “But most of our clients do. We’re owed 120,000 bolívares [about $56,000 at the official exchange rate] in overdue payments, and we’re down to 12,000 bolívares in the bank.” So goes Venezuela.



Argentina's legislative election

Double or quits

May 14th 2009 | BUENOS AIRES
From The Economist print edition

The Kirchners' electoral gambit

FOR Argentina's president, Cristina Fernández, and her husband and predecessor, Néstor Kirchner, this year's election for half the lower house of Congress and one-third of the Senate is no routine mid-term vote. With the economy deteriorating fast, Ms Fernández brought the poll forward from October to June 28th. Mr Kirchner, who is the president of the ruling Peronist party, is himself standing for the lower house in the all-important province of Buenos Aires, which contains two-fifths of the voters. An awkward, aloof figure, he has been out kissing babies and even allowing himself to be interviewed on television. In another unusual step he has packed the party's lists with more than 40 governors and mayors, plus the odd celebrity, all of whom say they have no intention of taking up their seats (which would be filled by others lower down the list).

All this smacks of a desperate, if cunning, gamble. The Kirchners' grip on power has slackened since they lost an acrimonious wrangle over taxes on farm exports last year. The IMF reckons the economy will shrink by 1.5% this year. Inflation is running at 19.8%, according to FIEL, a think-tank. And two different groups of opponents are stirring.

The first is a dissident coalition of conservative Peronists. It includes Francisco de Narváez, a wealthy businessman who is standing against Mr Kirchner in Buenos Aires province. He is spending a record sum on advertising, and has hired many of the marketeers who worked for Mr Kirchner in the past. He zips around the poor suburbs of the province in a private jet, trying to impress the mayors who are the vital local cogs in the clientelistic Peronist machine. It is to try to preserve the loyalty of the mayors that Mr Kirchner has made many of them congressional candidates.

The second is the Radical party, the traditional alternative to Peronism but recently much diminished and factionalised. In the past year or so the Radicals have begun to regroup. They are likely to gain ground in many provinces.

Pollsters suggest that Ms Fernández's government will probably lose its majority in the lower house, though not in the Senate. But by taking such a prominent role in the campaign, Mr Kirchner has raised the stakes. If his list performs strongly, he and his wife will keep their hold on power. If not, they will be hostages of the Peronist right and the opposition.



WORLD
ASIA

Pakistan's war with the Taliban

Fleeing the battlefield

May 14th 2009 | TAKHT BHAI
From The Economist print edition

Taking on Islamist militants exacts a terrible human toll

Getty Images



IMPATIENTLY awaited and enthusiastically cheered on by its American allies, the offensive by Pakistan's army against Taliban fighters in the Swat valley in North-West Frontier Province (NWFP) is understandably less welcome to the thousands uprooted by the fighting. Many of those sheltering among the rows of white tents at Jalala camp in Takht Bhai, in Mardan district, think the operation was necessary. But there is also anger and mistrust, and many agree with Umer Rachman, a shopkeeper from Mingora, Swat's main city, that the army relies too much on mortars and air power, killing civilians. He himself had helped bury five, killed by shelling in the city centre, in a single grave.

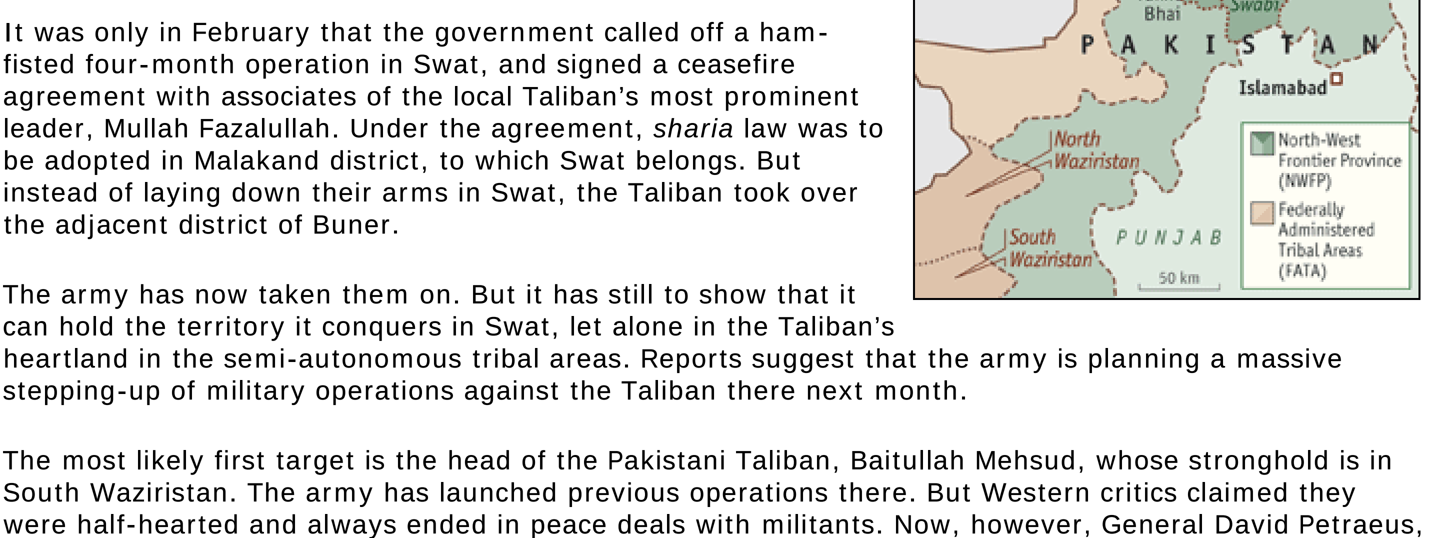
A recent survey by the International Republican Institute, an American NGO, found that 69% of Pakistanis thought that al-Qaeda and the Taliban operating in Pakistan were "a serious problem", and 45% supported the army's fight against them in NWFP and the tribal areas. That support, however, is fragile.

Like other camps built for refugees from Swat, Jalala has too few trees to offer more than sparse shade from the summer sun, and is full to capacity. But the stream of refugees from Swat, Buner and Dir is unrelenting. Many make the journey on foot, as lorry drivers are scared to transport them. Some new arrivals find the camp too crowded and move on to others in Swabi.

A senior military official claims about 800,000 civilians have fled the latest fighting. Relief agencies put the number between 240,000 and 400,000. They are joining about 500,000 displaced by earlier fighting in NWFP. However an official from a relief agency claims that the numbers of refugees have been exaggerated. Among the charities that have set up relief camps is Jamaat-ud-Dawa, an Islamic group that is in theory banned, as a front for the terrorists of Lashkar-e-Taiba.

The offensive began in earnest on May 8th, when Pakistani aircraft bombed Taliban positions in Swat. The previous day Yusuf Raza Gilani, the prime minister, had ordered the army to "eliminate" terrorists. The president, Asif Zardari, who was visiting Washington, vowed that the operation would last until "normalcy" had returned to Swat. The interior minister, Rehman Malik, then claimed that up to 700 Taliban militants had been killed in the fighting. A military spokesman said 29 soldiers had been killed and 77 wounded but could give no number for civilians killed. The army says 12,000 of its troops are pitted against 5,000 militants from a disparate mix of rival groups. It fears that if the Swat operation is not concluded quickly

these groups may unite under the central leadership of al-Qaeda and the Taliban.



On May 12th elite commandos flew by helicopter into the Peochar valley, which runs north-west of the main valley, to conduct search-and-destroy operations in the area housing a local Taliban headquarters. An army spokesman claims the militants are on the run. But in Mingora the Taliban still rule the roost, standing eyeball to eyeball with soldiers holed up in government buildings. On May 10th the Taliban executed Zahid Khan, imam of the town's main mosque, because he had objected to their stockpiling arms and laying landmines.

It was only in February that the government called off a ham-fisted four-month operation in Swat, and signed a ceasefire agreement with associates of the local Taliban's most prominent leader, Mullah Fazalullah. Under the agreement, *sharia* law was to be adopted in Malakand district, to which Swat belongs. But instead of laying down their arms in Swat, the Taliban took over the adjacent district of Buner.

The army has now taken them on. But it has still to show that it can hold the territory it conquers in Swat, let alone in the Taliban's heartland in the semi-autonomous tribal areas. Reports suggest that the army is planning a massive stepping-up of military operations against the Taliban there next month.

The most likely first target is the head of the Pakistani Taliban, Baitullah Mehsud, whose stronghold is in South Waziristan. The army has launched previous operations there. But Western critics claimed they were half-hearted and always ended in peace deals with militants. Now, however, General David Petraeus, the head of America's Central Command, has rightly asserted that there is a "degree of unanimity" among Pakistan's civilian and military leaders about the necessity of fighting the Taliban. Indeed, on May 12th members of the National Assembly, including the main conservative opposition party of Nawaz Sharif, backed the operation in Swat, though one religious party, Jamiat Ulema-e-Islam-Fazl, a government ally, protested.

Still sceptical over the Pakistani army's seriousness about eliminating the Taliban, Western analysts see its willingness to take on more powerful commanders as a gauge. One is Jalaluddin Haqqani, whose fighters battle Western forces in Afghanistan, and whom many senior Pakistani officers see as a useful asset through whom Pakistan can retain influence there. Tackling him would provoke a bloody backlash of suicide bombers. Another doubt is the durability of the government, a weak one led by an unpopular president in Mr Zardari. America is trying to bolster it by coaxing Mr Sharif into a power-sharing agreement. But, like previous American attempts to micromanage Pakistani politics, this one is probably doomed to fail.

The war in Afghanistan

A general's marching orders

May 14th 2009
From The Economist print edition

Why America’s commander in Afghanistan was fired

Bloomberg News



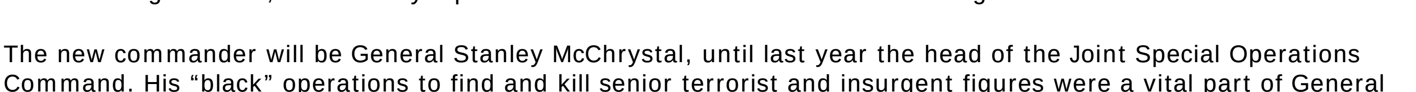
McKiernan, well-liked in Kabul at least

THE hit was carried out with all the speed and ruthlessness of a Delta Force night raid. On May 11th the Pentagon said that General David McKiernan, the NATO commander in Afghanistan, had been fired. Many in his staff expressed surprise. Asked whether the sacking would end the general’s career, Robert Gates, the defence secretary, replied: “Probably”.

This harsh dismissal of a general well-liked by many in Kabul is odd, as the fighting season gets under way with plans for a big American offensive in the south. General McKiernan’s star had seemed to be rising. His demand to strengthen operations in Afghanistan became orthodoxy under President Barack Obama, and he was given control of all forces there: NATO, American troops and special forces.

So what did he do wrong? Mr Gates said only that he wanted “fresh eyes”; with a new president, new forces, a new strategy and a new American ambassador, it was time to have a new commander (if not a new defence secretary). Pentagon officials said the sacking was unrelated to the killing of 100 or more civilians, allegedly by American forces, in Farah province this month. Some insiders complain that General McKiernan lacked dynamism.

Part of the answer lies in rivalries among America’s top brass: General McKiernan had led ground forces during the invasion of Iraq in 2003. His then subordinate, General David Petraeus, later celebrated for salvaging the mission in Iraq, is now his boss as head of Central Command. The new American ambassador to Kabul, Karl Eikenberry, a former general who had served in Afghanistan, was said by diplomats to have reservations about working with General McKiernan.



The new commander will be General Stanley McChrystal, until last year the head of the Joint Special Operations Command. His “black” operations to find and kill senior terrorist and insurgent figures were a vital part of General Petraeus’s success in Iraq, and General McChrystal is said to get on well with Mr Eikenberry.

The Pentagon wants to copy a winning formula from Iraq: a strong partnership between the ambassador and military commander to oversee a civil-military strategy, with day-to-day operations delegated to a powerful three-star deputy. This will be General David Rodriguez, who had a successful tour in Afghanistan as the head of the 82nd airborne division.

General McChrystal’s background raises questions about America’s intentions. Special forces have scored important military successes, for instance killing senior Taliban commanders. But they have also figured in some of the worst mishaps, in which large numbers of civilians have been killed in air strikes.

Some worry that General McChrystal’s arrival might herald a more aggressive approach, perhaps even across the border in Pakistan. Kai Eide, the UN envoy to Kabul, was quick to warn him that General McKiernan’s new rules to limit civilian deaths must be “respected”. “I hope they are not looking for a silver bullet; there isn’t one,” says one senior NATO commander.

Yet the change does reflect a determination, perhaps desperation, to show quick results. A Taliban spokesman said it was a sign of the Americans losing “patience and hope”. John Nagl, president of the Center for a New American Security, a think-tank, says: “McKiernan is a competent guy. But McChrystal is simply the best player in the field. It’s late in the innings—any team would use him.”



Sri Lanka's war

In blood steeped

May 14th 2009 | DELHI
From The Economist print edition

The feared carnage comes to pass

IT IS too late to warn of a civilian slaughter in north-eastern Sri Lanka. The “bloodbath [predicted] has become a reality,” said the UN’s spokesman in Colombo on May 11th, as news of the latest atrocity emerged from the crowded beach where the army and Tamil Tiger rebels are fighting their last battle. On May 9th and 10th 480 civilian refugees are reported to have been brought dead or dying to a makeshift hospital in the war-zone, victims of shellfire. A bigger number are alleged to have been buried uncounted in the sand. On May 12th and 13th the hospital itself was shelled, and around 100 people killed, according to doctors working there. The UN considers their testimony to be “consistently reliable”.

AP



Where there’s smoke, there’s a no-fire zone

According to the UN’s cautious estimate, over 8,000 civilians have been killed in the fighting since January 20th. It does not apportion blame for this. But Human Rights Watch (HRW), a research and lobbying group, accuses the Tigers of holding hostage the inhabitants of their former northern fief—and murdering some who tried to flee. And it says the army has “indiscriminately shelled densely populated areas, including hospitals, in violation of the laws of war.” Analysis of satellite images of the war-zone, cited by HRW, reveals that a thickly populated patch of the beach was somehow cleared between May 6th and May 10th. Analysts say the more recent images depict at least 19 possible shell-holes.

The government’s response to these allegations is dispiriting. It has lodged a complaint against the UN’s spokesman, Gordon Weiss. And it has reissued its allegation that the Tigers are shelling their own Tamil brethren in an effort to spur international calls for a ceasefire, which America, Britain and other Western countries have been requesting for weeks. The accusation is not implausible. Throughout a bitter, 26-year conflict, the Tigers have never balked at killing their own people. Yet this explanation has always seemed inadequate, with the government privately admitting to having sometimes shelled the “no-fire zone”, an area of the battlefield it declared as a sanctuary for entrapped refugees, of whom perhaps 50,000 remain. Under unprecedentedly heavy assault, most of the remaining Tigers retreated into this area early last month, and the army invaded it. The total battlefield, a sandy spar between a deep lagoon and the Indian Ocean, is now around 6.5 square kilometres (2.5 square miles).

To rally its domestic support, the government has been predicting imminent victory for months, while its lackeys deride its foreign critics as Tiger-strokers and imperialists. Meanwhile, the army is also suffering. When the government last admitted its casualties, late last year, it said 3,800 troops had been killed in an 18-month offensive. Its casualty-rate has since been much higher. P.D. Gnanawathie, a migrant to Colombo from central Sri Lanka, where the army has recruited heavily, laments the mounting number of dead youths from her village. According to the army, over 20,000 Tiger fighters have been killed. In Vavuniya, where most of the 170,000 Tamil fugitives from the war-zone have been interned in

government-run camps, field-hospitals are swamped with the wounded. A Western doctor there says he has seen suffering worse than he witnessed in Congo and Sudan.

Foreign condemnation of its means serves only to harden the resolve of President Mahinda Rajapaksa's government to achieve its end, the crushing of the Tigers. Gotabhaya Rajapaksa, the president's brother and defence secretary, says the fighting will go on until the rebels, now estimated at just a few hundred seasoned fighters, have been destroyed. Above all, the government wants to wipe out the senior Tigers, including Velupillai Prabhakaran, a vicious supremo it reckons to be still alive and on the battlefield. A ceasefire, it fears, would allow him to wriggle free.

Moreover, the government argues, most Sri Lankans—meaning primarily the ethnic-Sinhalese majority that elected it—support its war-plan. Mr Rajapaksa's ruling coalition has won a series of regional elections, most recently in Western Province, the country's richest, on April 25th. But as the death-toll rises, and the war drags on, even this constituency is getting impatient. According to Mr Rajapaksa, the defence secretary, most Sri Lankans want the government "to finish this damn thing off soon". In this mood, calls for restraint are unlikely to sway the army.

Nepal's political crisis

Maoists required

May 14th 2009 | KATHMANDU
From The Economist print edition

The peace process still on life-support

THE incompetence of Nepal's self-regarding politicians helped fuel a nasty decade-long war, mercifully ended in 2006. Now, charged with working alongside the Maoists who fought the war to safeguard a delicate peace process, and write a new constitution to lead Nepalis to the light, they are blundering again.

The resignation on May 4th of the Maoists' leader, Pushpa Kamal Dahal, as prime minister has left the government in limbo. Mr Dahal was protesting at being foiled in his effort to sack the country's army chief, General Rookmangud Katawal. The sacking was vetoed by the president, Ram Baran Yadav, with encouragement from almost every other political party. United in their suspicion that the Maoists' recent commitment to democracy is a sham, the former guerrillas' two biggest opponents, a mainstream leftist party known as the UML (for "Unified Marxist-Leninist"), and the Nepali Congress party (NC) are now trying to form an alternative government.

That requires support from a majority of the 601-member Constituent Assembly. And with only 212 seats between them, the UML and NC are struggling. Even with support from a dozen small parties, they need backing from Nepal's fourth-biggest outfit, an alliance of parties dedicated to the Madhesi ethnic group, known as the United Madhesi Democratic Front. The Madhesis seem willing; but they want a promise that the new government would grant them an autonomous Madhesi province in the southern Terai region.

The difficulty of making a non-Maoist government is a clue to how misguided it would be. Mostly drawn from Kathmandu, a pampered capital, the Maoists' opponents have consistently underestimated them and the rural grievances that fuelled their struggle. The UML and NC both expected to win the country's first post-war election last year. But the Maoists triumphed, winning 38% of the seats. Wiser than their politicians, Nepalis wanted the former guerrillas to prove their democratic credentials. Even if the Maoists now do so in opposition, as Mr Dahal says they would, they will be able to block a weak and fractious government on most issues. Moreover, despite Mr Dahal's pledge, the Maoists have stopped the assembly functioning since his resignation. Unless Mr Yadav withdraws his support for General Katawal, they say they will not return to the government—but that any alternative administration would be illegal.

With a history of unstable coalitions, many Nepali politicians appear to think this mess normal. But with a peace to be won and constitution to be written, for which political consensus is required, these are not normal times. According to a 2006 peace agreement between the Maoists and their political opponents, some of the Maoists' 23,000-odd former fighters, currently in UN-supervised camps, should be integrated into the army. But General Katawal, egged on by the NC, UML and India, has resisted this. Indeed, many Nepali politicians say the agreement should be renegotiated, arguing that the Maoists have not kept their side of the bargain, for example by failing to control their thuggish youth wing. That is true. But tearing up the peace agreement will hardly encourage the Maoist leaders, with their standing army outside Kathmandu, to honour it.

The Sichuan earthquake

Salt in their wounds

May 14th 2009 | JUYUAN
From The Economist print edition

Bereaved parents treated like criminals

“CITIZENS of the disaster zone are marching towards a new life,” proclaimed China’s president, Hu Jintao, on May 12th, a year after an earthquake in Sichuan Province left more than 86,000 dead or missing and millions homeless. But for all Mr Hu’s talk of the victory won by China’s colossal relief efforts, some survivors are deeply unhappy.

China’s immediate response to the earthquake won international praise for its speed and openness. Journalists, who are often kept away from disaster scenes, were given largely unfettered access. But officials soon began trying to limit their access to the angry relatives of the thousands of children crushed to death by collapsing school buildings. While Mr Hu spoke at a ceremony attended by foreign diplomats in the badly hit town of Yingxiu, close to the epicentre, police around the zone were on heightened alert to prevent parents from airing their grievances.

AP



Remembering what was lost in the rubble

In the town of Juyuan, about 20km (12.5 miles) south-east of Yingxiu, police surrounded the fenced-off remains of a middle school where hundreds of children were killed. Foreign journalists now have to register with the government to report from the earthquake zone. Officials in Dujiangyan, a nearby city, insisted that a government minder accompany your correspondent to Juyuan. But once there, three black-shirted security agents soon put a stop to the tour. They drove the visitors to a police station where an officer declared that Juyuan was under “special controls”.

Buildings near Juyuan Middle School show few visible signs of earthquake damage. Parents suspect that this is because they were better constructed than the school’s two collapsed buildings. In the days after the earthquake, senior officials vowed to investigate whether shoddy construction was to blame for the destruction of more than 7,000 classrooms in the disaster. But the issue was soon played down. It was not until a few days before the anniversary that the government finally gave a figure for the number of students killed or missing: 5,335. But officials also insisted that not one school had collapsed because of poor building quality.

Some of Juyuan’s bereaved parents are not convinced. The father of a 15-year-old boy killed in the middle school accuses the local government of fearing a public investigation “because there is corruption involved”. Officials ordered this man and several other parents to join a sightseeing trip on May 12th, apparently to keep them out of town over the anniversary. Because of China’s strict family-planning policy, many of the parents had only one child.

In Beijing, a prominent artist, Ai Weiwei, famous as a designer of the “bird’s nest” Olympic stadium, has organised a team of more than 50 volunteers to travel around the earthquake zone and collect the names of students who were killed (he believes there were more than 7,000) and record interviews with their parents. He says team members have been stopped by police more than 20 times. The police usually confiscated or erased their recordings and threatened further retribution if they continued their work. On two occasions, volunteers were beaten. Several of the victims’ parents as well as foreign journalists have suffered similar thuggery. Parents have been warned not to protest. Some who have refused have been told they will be treated as supporters of Falun Gong, an outlawed sect, or of Tibetan independence, says Mr Ai.

Officials have not directly attempted to stop Mr Ai’s activities, but internet portals in Beijing often remove blog postings with updates on his name-gathering mission. In March police in Sichuan arrested an activist, Tan Zuoren, engaged in a project similar to Mr Ai’s. He is still in custody, as is Huang Qi, who was charged

last year with possessing state secrets after gathering information on collapsed schools.

Mr Ai says the refusal of central leaders to admit policy failures has exacerbated parents' frustration. In the 1990s, he says, shoddy school buildings were erected across China because of the government's drive to provide enough classrooms for all children to undergo nine years of compulsory education. Building costs were supposed to be shared by central and local authorities, but the latter often failed to chip in. This led to quality problems.

A law took effect this month requiring that schools and hospitals be built to withstand quakes of magnitude eight, about the scale of Sichuan's. This will be only a crumb of comfort to Juyuan's grieving parents. They say local officials have banned them even from visiting the school's weed-filled compound to mourn.

Malaysian politics

Practising in Perak

May 14th 2009 | BANGKOK
From The Economist print edition

For federal battles to come

WHEN three legislators in Perak, one of five of opposition-ruled Malaysian states, switched sides in February, overturning a narrow majority in the 59-seat assembly, the United Malays National Organisation (UMNO) was cock-a-hoop. After a big electoral setback last year, the long-dominant UMNO was at last taking the fight to the opposition, led by its nemesis, Anwar Ibrahim, a former deputy prime minister. Loyalists credited the defections, reportedly induced by the threat of corruption probes, to the bare-knuckle tactics of Najib Razak, since sworn in as prime minister in place of the mild-mannered Abdullah Badawi. Taking back Perak was just the start, UMNO snarled.

Perak was indeed the start of something, but not the rollback of Malaysia's opposition, as foreseen by UMNO and its ruling coalition partners. Instead it has snowballed into a constitutional crisis that reveals the wobbly underpinnings of a democracy yet to be tested by a handover of power at the federal level. On May 7th, amid scuffles at Perak's parliament, UMNO's man was installed as chief minister. Scores of people were arrested, including the speaker of the house, who was bundled away by plainclothes police. He had objected to the takeover as it had never been put to a vote in the assembly.

On May 11th it was the opposition's turn to crow. The High Court ruled that its man, Nizar Jamaluddin, was still the chief minister of Perak as his removal in February was illegal. He had been removed not, as is usual in parliamentary systems, by his elected peers but by Perak's sultan, one of Malaysia's hereditary state rulers. Sultan Azlan Shah had sealed the controversial takeover on February 5th, ignoring an appeal from Mr Jamaluddin to dissolve the house and hold snap elections.

The opposition's euphoria was short-lived. The next day UMNO successfully obtained a stay from an appeals court against the reinstatement of Mr Jamaluddin. That decision allowed Zambry Kadir, UMNO's candidate, to return on May 13th as caretaker chief minister. Grotesquely, in a blog posting, Mr Kadir likened his grubby power play to the struggles of Nelson Mandela and Mahatma Gandhi.

A fast-track deliberation by the appeals court should resolve the case in the next week or so. But the political fallout is much harder to fix. Should the obstreperous assembly reconvene, more scuffles are likely, says James Chin, a political scientist at Monash University's campus in Kuala Lumpur. One way out, it seems, is to hold fresh elections in Perak. Yet that is exactly what UMNO fears most after a run of embarrassing defeats in state and federal polls. Ministers complain that by-elections are a waste of public money. In the case of Perak, the legal and legislative routes have not been exhausted, argues Khairy Jamaluddin (no relation), a senior UMNO official.

The opposition is expected to win again in Perak, as it did in March 2008 in an election that saw the UMNO-led National Front lose its cherished two-thirds majority in parliament. Mr Anwar subsequently sought to persuade 30 ruling MPs to cross the floor, the same tactic used in Perak. His advisers argued that this was justified as he planned to dissolve the house and return power to the people, betting on victory. In the end, Mr Anwar's carrot went unbitten. But it dangles still, and UMNO knows it.

The bigger question posed by the proxy war in Perak is what happens if the levers of federal power should one day slip from UMNO's hands, as has seemed inevitable since last year's election. Entrenched political elites rarely go quietly. A politicised civil service and security apparatus might resist an opposition victory, and look to the judiciary and, possibly, the sultans for support. Mr Anwar knows this, and is courting power-brokers in the system. But the danger of civil unrest should not be dismissed lightly. That is particularly true if UMNO decides to play on tensions between Malaysia's majority Malays and its ethnic-Chinese and Indian minorities.

Until the Perak storm broke, Mr Najib had been steering a mildly reformist course. A handful of political prisoners have been freed, including ethnic Indians jailed after rowdy anti-government protests in 2007. Regulations on Islamic banking and insurance, and on local-ownership restrictions in selected service

sectors were liberalised. But the core grievances of non-Malays over statutory privileges for the Malays remain. These privileges, staunchly defended by UMNO, were introduced in 1971, two years after deadly race riots in Kuala Lumpur. The riots began after UMNO suffered election losses to Chinese-based opposition parties. The date, by coincidence, was May 13th 1969.

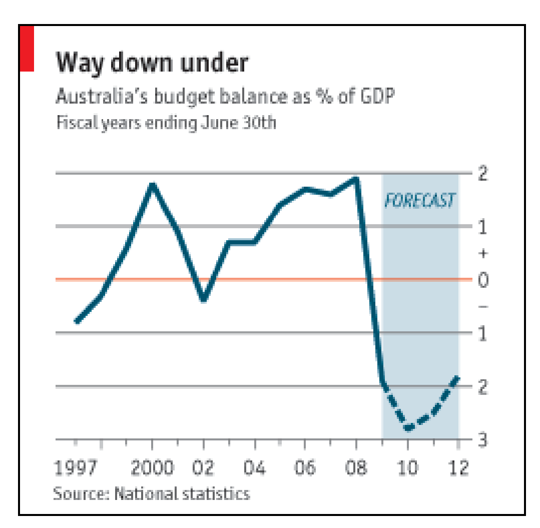


Australia's budget

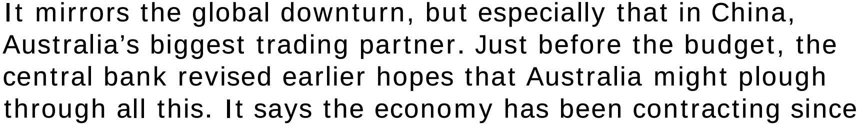
Stimulating stuff

May 14th 2009 | CANBERRA
From The Economist print edition

Rudd pins his hopes on Australia's luck holding



FOR more than a decade, Australia had enjoyed one of the biggest booms in its history, and a robust series of budget surpluses. When Kevin Rudd led the Labor Party to power in 2007, he promised, as a "fiscal conservative" to keep this ball rolling. But when Wayne Swan, his treasurer (finance minister), presented the government's second budget on May 12th, the ball had suddenly stopped. Mr Swan delivered an underlying cash deficit for 2009-10 of almost A$58 billion ($44 billion), or 4.9% of GDP, one of the largest ever. Only last year, an A$20 billion surplus was forecast. The lucky country's reversal of fortune could hardly have been starker.



It mirrors the global downturn, but especially that in China, Australia's biggest trading partner. Just before the budget, the central bank revised earlier hopes that Australia might plough through all this. It says the economy has been contracting since late last year, and it will shrink by 0.5% up to mid-2010. This may sound mild compared with other rich countries. But the slump in commodity markets and prices has blown a hole in record company profits that underwrote much of the boom. The Treasury says that tax revenues over the next four years will now be A$210 billion less than expected.

This posed a stark choice for Mr Rudd. He has promised big spending on health, education and attacking climate change. Now, he has either to find some way of financing his plans, such as tax hikes, or to drop them. He chose neither course. Buoyed by public and pundit support for two stimulus packages since October, he turned the budget largely into a third stimulus. It invests A$22 billion in infrastructure, including ports, interstate roads and new railways in Australia's big cities. Clean-energy projects, mainly solar and carbon capture from burning coal, will get A$4.5 billion. Under pressure from an unlikely alliance of business and greens, Mr Rudd recently delayed by a year his plan for an emissions-trading scheme from 2010. The green budget measure turns the pressure back on his critics.

Mr Rudd plans to pay for all this by finding savings roughly equal to the infrastructure outlays. Richer Australians will sacrifice most. The government will slash tax breaks for private health insurance, pension contributions and other forms of middle-class welfare. Nevertheless, the government faces net debt to the tune of almost A$200 billion in four years from money it will have to borrow to cover projected deficits.

But luck has not entirely deserted Australia. Having shunned toxic assets, its four big banks look healthy. The Treasury is predicting that growth will return to boom levels of 4.5% in just two years. That must assume China's demand for Australia's commodities revives. The contraction, meanwhile, is expected to raise unemployment to 8.5%, or about 1m people, by mid-2011. This will worry Mr Rudd as he faces an election by the end of 2010. For now, he has avoided imposing quite the horror budget many had feared.

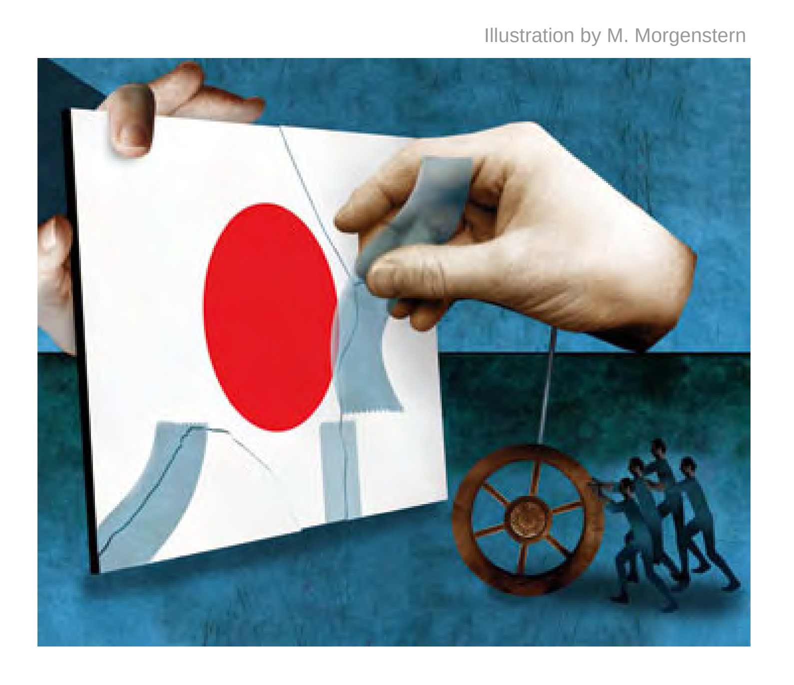
Banyan

Creative destruction

May 14th 2009
From The Economist print edition

The need for change in Japan is pressing, but the callow opposition hardly seems up to the job

Illustration by M. Morgenstern



THERE is no revolution at the barricades, and on an early-summer Sunday the homeless in Tokyo's Yoyogi park form a polite long queue for the *bento* (packed lunch) boxes being handed out by a schoolgirl from a local church: the deepest bows come from those at the back who go away empty-handed. Yet as far as the problems of a rich country go, it is hard to exaggerate Japan's.

The global slump has hit the economy far harder than the famous bursting of its bubble did two decades ago. Government debt stands at twice the economy's annual output, dwarfing even Italy's. The export-led growth which drove a six-year recovery after 2002 has proved a chimera. Now, as Japan's 127m-strong population is set to fall, some predict, by more than a third over the next few decades, the working-age population will fall fastest, before a way has been found to pay for all the grey heads. Yet, under a nutty-sounding new policy the government is quietly bribing South American immigrants of Japanese extraction to return home for good. Other solutions to the crisis proposed by members of the ruling Liberal Democratic Party (LDP) include creating a brand-new currency, with which to flood the economy. Much else about the LDP is either crackpot or forlorn, suggesting that Japan's problems are political at root. And now, for the first time in Japan's post-war history, an opposition offers a feasible alternative to the LDP, which has run Japan for all but ten months since 1955.

Until this week, however, which brought the resignation of Ichiro Ozawa, imperious leader of the opposition Democratic Party of Japan (DPJ), that feasibility had once again been in doubt. Victory in the general election, which the prime minister, Taro Aso, is bound to call by September, was the DPJ's to lose. Mr Ozawa seemed determined to lose it. Not for nothing is he known as "the Destroyer". This spring he was implicated in a fund-raising scandal, in which an aide was indicted for receiving illegal donations from a construction company. That went down poorly with voters, underscoring how much Mr Ozawa's politics were still rooted in the murk of back rooms.

The 66-year-old Mr Ozawa had started out in the LDP, where his rise was as astounding as the quantities of enemies he made. Earlier than any politician, he had articulated the need for political reform and for Japan to come out from under its pacifist constitution to chart a more "normal" course in foreign affairs, shouldering more of the burden of its own defence. He defected from the LDP in 1993 and, as the DPJ's head, has turned the party into a national force not just among the urban middle classes but in rural regions too. The strategy paid off in 2007, when the party won control of the upper house of the Diet

(parliament), throwing the LDP into disarray. It is on its third prime minister since.

The latest scandal, however, had turned Mr Ozawa into an electoral liability for the DPJ. Stepping down may prove to be a rare constructive act in the Destroyer's career. His successor will present a fresh start in promoting a reformist agenda of fixing the pension and health systems, providing jobs and making government and bureaucracy more accountable.

"Fresh", however, is hardly the apt term for the two contenders for the leadership, to be decided on May 16th. One, Yukio Hatoyama, the secretary-general, is closely associated with the former leader and will be backed by Mr Ozawa's henchmen. Mr Ozawa himself may expect to wield more power from behind the throne than on it. The other, Katsuya Okada, led the DPJ to a crushing defeat in 2005 by the LDP under its former prime minister, Junichiro Koizumi. Fatally, he opposed Mr Koizumi's popular plans to privatise the postal-savings system. Both DPJ contenders are charisma-light insiders. But at least Mr Okada, who has admitted his 2005 electoral blunder, has hit a nerve in promising to campaign against the practice, common among LDP political families, of treating Diet seats as heritable sinecures. Over half Mr Aso's cabinet are the offspring of former politicians.

Searching for the new

Even so, the DPJ hardly offers a clean break with the sordid past. Like its predecessor as pretender to the LDP's crown, the Socialist Party, it has tended to be a rather tame opposition. Many of its members, indeed, are ex-Socialists. Others, Mr Hatoyama and Mr Okada included, are from the LDP. Mr Hatoyama has a brother in the cabinet. His grandfather, Ichiro Hatoyama, was an LDP founding father and arch-rival to Japan's most notable prime minister after the war, Shigeru Yoshida. Mr Yoshida, as it happens, was Mr Aso's grandfather, so this summer's election may play out as family rivalry. Further, the political careers of both Mr Hatoyama and Mr Okada have been bankrolled by immense family fortunes, just like those of many in the LDP. *Plus ça change*.

With Mr Ozawa gone, establishment meddlers, such as retired prime ministers and media magnates, will redouble efforts to get the LDP to propose a post-election "grand coalition" with the DPJ. After all, many have long viewed it as merely an errant LDP faction. Elsewhere, modernisers within the LDP are pondering defecting to the DPJ. Given the DPJ's inexperience—one reason why it depended so on Mr Ozawa—they might be welcome.

So the big test facing the DPJ is to dispel the suspicion that politics in Japan, more than any other rich democracy, is a top-down business arranged by a self-selecting elite, which rarely informs the public of its actions, much less consults them. Voters, of course, have in part themselves to blame for this. To date, they have too readily accepted what they are given, even when the political *bento* boxes prove empty. When they line up at the ballot boxes this summer, a resounding vote for the DPJ would show Japanese politicians they are accountable after all, and offer a chance to see if the DPJ can keep its promises. It might even elicit an explanation as to how the party is to pay for them.

America's new diplomacy

Barack Obama, poised to plunge

May 14th 2009 | CAIRO
From The Economist print edition

America's president is set to get involved in one of the world's trickiest regions

Illustration by Peter Schrank



BY MANY measures, prospects for unpicking the Middle East's intertwined tangles look as slim as ever. On the core question of Palestine, what may be the Israelis' most intransigent government ever elected faces off against a deeply divided and dysfunctional Palestinian camp. A chill of cold war is creeping across the region, with a frighteningly nuclear-bound Iran and its varied allies who reject Israel confronting an array of pro-Western moderates looking more beleaguered. And meanwhile America, the traditional outside interlocutor, having haemorrhaged diplomatic credibility throughout the eight years of George Bush's presidency, has plenty of distractions at home.

Yet Barack Obama's administration looks poised to wade into the Middle Eastern bog. Early on, America's popular president indicated his seriousness by appointing George Mitchell, a seasoned peacemaker, as his Middle East peace envoy, and by dumping Mr Bush's policy of refusing to talk to America's adversaries.

American diplomacy is now shifting into higher gear. With American officials hinting at bolder aspirations, Mr Obama has invited a stream of regional leaders to Washington. In early June he plans to deliver a speech in Cairo, Egypt's capital and the biggest Arab and Muslim city, to fulfil a promise to address the world's 1.3 billion Muslims in a bid to restore American prestige and perhaps also to lay out a vision big enough to jolt the region's cynics and spoilers out of their negative obstinacy.

Many regional actors dislike what they are beginning to hear. Israel's government, for one, looks increasingly discomfited by the new wind blowing from Washington. Its new prime minister, Binyamin Netanyahu, argues, among other things, that Mr Obama should somehow spike Iran's nuclear ambitions before pushing Israel to address the Palestinians (see article).

For sure, America also views Iran's nuclear ambitions and its support of Islamist guerrilla groups in such places as Lebanon and the Gaza Strip as threats. But in contradiction to Israel's insistence that the option of using force against Iran must be maintained, America's secretary of defence, Robert Gates, has cautioned that a military attack would only delay rather than destroy its nuclear programme.

Mr Obama's quietly tough national security adviser, James Jones, has remarked pointedly that working towards a two-state solution of the Palestinian question could do a great deal to diminish Iran's threat. He also invokes the experience of Yugoslavia to explain that in pursuing peace it is more effective for America to be involved directly in negotiations rather than leave parties to sort things out: a hint that America may not shy from squeezing its Israeli ally. Susan Rice, America's representative at the UN, endorsed a unanimous Security Council call to create a Palestinian state. Unusually for an American official, she used such terms as "fully", "unequivocally" and "urgently".

Yet the Arab and Muslim rejectionists are also less than delighted by America's new tune. Iran's leaders sniff that they want to see action, not just nice words. Their ally Syria, basking in recent Western courtship and sensing that the world has recognised its wisdom in supporting "resistance" movements and its indispensability to any regional progress, got a recent shock when Mr Obama ordered a renewal of American sanctions against it.

The Palestinian Islamist movement, Hamas, and Lebanon's militia-cum-party, Hizbullah, cheered by Europe's less hostile attitude to them and hopeful that America may one day stop demonising them as terrorists, are still shunned, though it is likely that Mr Mitchell is quietly pondering ways to draw them into dialogue, perhaps at first through third parties. After all, both movements remain powerful potential spoilers. Hizbullah looks set to make gains in Lebanon's imminent elections—and could play a bigger part in the next Lebanese government. And without Hamas, no Palestinian government is likely to strike a deal with Israel that would stick.

Still, Mr Obama's efforts are beginning to generate support and even enthusiasm. King Abdullah of Jordan, the first Middle East leader to be received at the White House by its new incumbent, says the Americans now accept the urgency of a need to build momentum towards a comprehensive peace. He also reckons they realise, as Mr Bush's team never did, that almost all Arabs and Muslims would recognise Israel if it relinquished the Palestinian territories under occupation. President Hosni Mubarak of Egypt, a staunch American ally whose relations with Mr Bush grew strained to breaking point, praises the new American president as precise, reasoned and willing to listen, in sharp contrast to his predecessor. Meeting Mr Netanyahu before both of them were due to go to Washington, he was careful to insist that pursuing peace with Palestinians, not confronting Iran, should be the priority.

Mr Obama has advantages that his predecessor never enjoyed. He has unusually strong backing in the world at large, which shares his impatience to settle the Middle East's squabbles. He is still personally popular abroad. In a recent poll of six Arab countries he was viewed far more favourably than America itself. Most Arabs think he will have a good effect on the region.

But by raising expectations of a big diplomatic push, Mr Obama risks damaging American credibility more, should his efforts prove vague or toothless. Huge obstacles remain, not just regional saboteurs but also an American Congress still reluctant—though a shade less so than before—to flout Israel's wishes. But behind the as-yet-undefined specifics of American policy, there appear to lie some new assumptions that augur well for success. One is that regional peace must be sought as a goal, not a process. Another is that the region's troubles are all linked. Perhaps the most important is that in seeking to fix things, America will be acting neither out of charity nor in pursuit of ideological ambition but simply in its own national interest.

Israel and America

Does he really want a deal?

May 14th 2009 | JERUSALEM
From The Economist print edition

Binyamin Netanyahu comes to talk to Barack Obama

AP



Netanyahu waits for the headmaster

THE more he can talk about the wider region, the less he need focus on the narrow, awkward issue of the Israeli-Palestinian conflict. That, at any rate, is a perennial suspicion about Binyamin Netanyahu, Israel's once-again prime minister, which he will try to allay when he arrives in Washington for his first meeting, on May 18th, with Barack Obama.

He will want to talk to the president at length, say Mr Netanyahu's people, about Iran's nuclear ambitions, the most pressing and dangerous problem in the eyes of Israel's government. Mr Netanyahu discerns "an unprecedented convergence" of interests between Israel and moderate states in the region in the face of a perceived threat from Iran and Hizbullah, the well-armed Shia political movement Iran sponsors in Lebanon. But the Israeli prime minister says this is "irrespective" of his willingness, indeed his desire, to proceed with "parallel" talks with the Palestinians. He would, of course, discuss those talks too with Mr Obama.

He will also want to discuss new ideas apparently evolving in Washington about a broad regional rapprochement. King Abdullah of Jordan, a recent guest at the White House, speaks of "a 57-state solution" between Israel and the entire Muslim world, embracing the full membership of the Organisation of the Islamic Conference. Mr Netanyahu says this "dovetails" with his own public statements and private urgings that leading regional governments should be more active in diplomacy aimed at making peace with Israel. He apparently made the same point to Egypt's president, Hosni Mubarak, at the resort town of Sharm el-Sheikh on May 11th. But he is said to acknowledge a need to make progress directly with the Palestinians.

But how? Israeli officials leave that vague, hinting that Mr Netanyahu may unfurl a new plan in Mr Obama's presence and then show it to the world. He denies a report that he sought to meet the leader of the Palestinian Authority, Mahmoud Abbas, but was rebuffed. In any event, the two leaders will not have met before each presents his case at the White House; negotiations between the Palestinian Authority and Israel have, in effect, been suspended since the previous Israeli government of Ehud Olmert left office on April 1st.

The Palestinians want Israel's new government to accept a two-state solution, to stop building settlements and to resume the talks where they were left off. Mr Netanyahu says he wants to talk—but "without preconditions". His officials say that no government need accept the negotiating positions of its predecessor unless they were enshrined in a signed agreement, which they were not.

In contrast, senior people in Mr Obama's team have been loudly insisting, in a string of statements intended to soften Mr Netanyahu up before his White House encounter, on the need for a two-state solution and for settlement building to stop. "You're not going to like my saying this," the vice-president, Joseph Biden, told the American Israel Public Affairs Committee (AIPAC), a powerful lobby, at its convention in Washington earlier this month. Israel should "not build more settlements, [it should] dismantle existing outposts and allow Palestinians freedom of movement …and access to economic opportunity."

Mr Netanyahu's men claim this was not a scolding: the vice-president spoke of "more" settlements and Mr Netanyahu's government says it will merely permit the expansion of existing ones rather than build "more". His government, like its predecessor, says it will indeed take down "illegal" outposts, meaning those that have not been sanctioned even by Israel's government; its predecessor's promise to do so was

honoured mainly in the breach.

Such semantic bobbing and weaving may remind Mr Obama’s team, especially those in it who once worked for President Bill Clinton, of Mr Netanyahu’s fraught previous term as prime minister, from 1996 to 1999. “That SOB doesn’t want a deal,” growled Mr Clinton at a particularly frustrating juncture in diplomacy. It remains to be seen whether—or how fast—Mr Obama may come to the same conclusion.

A press row in Qatar

The limits to liberalisation

May 14th 2009 | DOHA
From The Economist print edition

A freedom-promoting media centre is accused of going too far too fast

WHEN the Qataris asked Robert Ménard to run what they heralded as the world’s first press freedom centre, in Doha, their capital, they were probably asking for trouble. An intrepid Frenchman who had previously run a Paris-based lobby, Reporters Without Borders, Mr Ménard is famous for courting controversy. Last year he disrupted a torch-lighting ceremony in Greece that was meant to be a dignified prelude to the Olympic games in China. Later he scaled Notre Dame Cathedral and unfurled a protest banner as the torch was carried through Paris. Now, only months after becoming head of the Doha Centre for Media Freedom, he is entangled in a row that may well be more bitter than anything he has experienced.

The centre was launched only in October. Its supporting luminaries include Dominique de Villepin, a former French prime minister; Daniel Barenboim, a conductor; and Mia Farrow, an actress who cares about human rights. The centre aims to help imperilled journalists and promote press freedom everywhere. Qatar’s emir endorsed it; his wife, Sheikha Mozah, who heads the vastly rich Qatar Foundation, paid for it. The centre’s chairman also chairs the Qatari-owned al-Jazeera, the Arab world’s most popular television channel, which gives the little kingdom an influence far above its size or wealth.

Yet Qataris were clearly misguided if they believed Mr Ménard would change his florid and unabashed style of operation to suit his benefactors’ temperament. And Mr Ménard was equally misguided if he believed that a conservative society, not many decades removed from its Bedouin roots, would tolerate the permissive media practices of the West.

Rifts between Mr Ménard and Qatari officials began to open earlier this year when the centre, which runs two safe houses in Doha for journalists under threat, found that visas for some of those seeking shelter were being denied. In March Mr Ménard wrote an open letter to Sheikha Mozah on the centre’s website, telling her that “some people close to you and others you have appointed to senior positions at the centre” were obstructing its activities. One of those Mr Ménard accused was a Qatari, whom he fired.

Even in a Gulf autocracy as relatively liberal as Qatar’s, publicly chastening a high official can be rash. Moreover, Mr Ménard soon rattled his patrons with his zeal for change. An editorial in *al-Sharq*, a leading Qatari newspaper, soon accused him of endorsing pornography after he objected to internet censorship in Dubai, one of the nearby United Arab Emirates, where police had tried to block pornographic and anti-religious websites. Mr Ménard said his centre filtered out pornography aimed at the young. Then he was attacked in other editorials, each seemingly fiercer than the one before, in the local press.

Coincidentally but as if on cue, it was World Press Freedom Day earlier this month, an annual event jointly organised by the UN’s Educational, Scientific and Cultural Organisation (UNESCO) and the Doha media centre, that gave Qatar’s press, which Mr Ménard says was operating “under orders”, its latest opening. Apparently without the knowledge of Mr Ménard or the centre’s staff, Flemming Rose, the cultural editor of *Jyllands-Posten,* the Danish daily that published the controversial cartoons of the Prophet Muhammad four years ago, had flown to the conference. He was accompanied by his boss, Jorgen Ejbol, who chairs the group that owns the offending newspaper—and co-sponsors UNESCO’s Press Freedom Prize.

An editorial in a local Qatari daily, *al-Watan*, promptly accused Mr Ménard of welcoming the Danish “Satan” to Doha. “Ménard should know there is a red line in media freedom which you cannot cross,” the editorial thundered, accusing the Frenchman of insulting all Muslims. There followed heated exchanges in the local assemblies, irate telephone calls to the interior ministry, angry e-mails to the centre’s staff telling them to leave, and at least one Qatari mosque sermon during Friday prayers that lambasted the media centre.

Mr Ménard says the row is really between conservatives and liberals in Qatar itself. “I know of no other country in the Arab world that would have had the courage to open the centre” and invite a critic into their midst, he says, lauding the emir and Sheikha Mozah. Closing the centre, he says, would be a defeat not only for liberalisation but also for the image of Qatar. For the royal rulers, it will be a hard choice.

South Africa's new government

Who will call the economic shots?

May 14th 2009 | PRETORIA
From The Economist print edition

It is unclear whether the former finance minister will retain his authority

AFTER South Africa's new president, Jacob Zuma, named his cabinet on May 10th, he was asked what his priority would be, among the myriad promises he had made on his long journey to the country's top spot. "My *rooibos* tea, honey and lemon," was his homely answer. *Rooibos*, pronounced "roy-boss", Afrikaans for "red bush", makes a brew with a flavour that is deliciously unique—so its drinkers say—to South Africa.

Joking apart, the most-watched post in Mr Zuma's new cabinet is the finance minister, who for the past 13 years has been the fiscally conservative, well-respected Trevor Manuel. South Africa's business establishment and foreign investors have been nervous lest Mr Zuma, as a sop to his many vocal supporters on the left, would get rid of him. The trade unions and the South African Communist Party, both boosters of Mr Zuma on his way to power, have long complained that the National Treasury under Mr Manuel had become too powerful.

So there was an early frisson when Mr Zuma shifted him to another post. But the new president may have been displaying his instinct to try to please all sides. Mr Manuel may have even more authority in his new job as head of a new national planning commission. Along with another minister in the presidency, Collins Chabane, he will oversee the implementation of overall policy—from Mr Zuma's office. "Manuel understands government very well and therefore he has been given that task," says the president. The commission, he notes, is a "very powerful structure".

Indeed, it has the potential to become the presidency's de facto executive arm. Mr Zuma, who has no clear-cut ideology of his own, is not one for wading through lengthy position papers or scrutinising the minutiae of government. "I think Zuma understands his own limitations in terms of policy," says Ivor Jenkins of the Institute for Democracy in South Africa, adding that the new head of state would rather "be seen as the public face, the reconciler, the good guy, and have someone in the back room running the thing."

AFP

But it is not yet clear how the commission will be able to enforce its will. When Mr Manuel was finance minister, he had ultimate control of the purse-strings. His successor is Pravin Gordhan (pictured left), previously an efficient head of the tax-collecting department, who, despite a background in the Communist Party, is generally deemed economically orthodox. "I suspect he's a social democrat and a pragmatist, not a central planner," says Anthony Butler, professor of public policy at the University of Cape Town.

The appointment shows how Mr Zuma must balance competing interests now that he is at last in charge. He has accumulated multiple and sometimes conflicting obligations while building a coalition in the ANC against Thabo Mbeki, who succeeded Nelson Mandela as president and was ousted by Mr Zuma's allies last year. Some people in left-wing groups keen on Mr Zuma have got junior ministries in the new government, such as economic development and higher education. But those who feared an early slide towards populism were relieved when Mr Zuma failed to give a post to Winnie Madikizela-Mandela, the former president's divorced wife, who was convicted of fraud and theft in 2003 but who still has a rumbustious following.

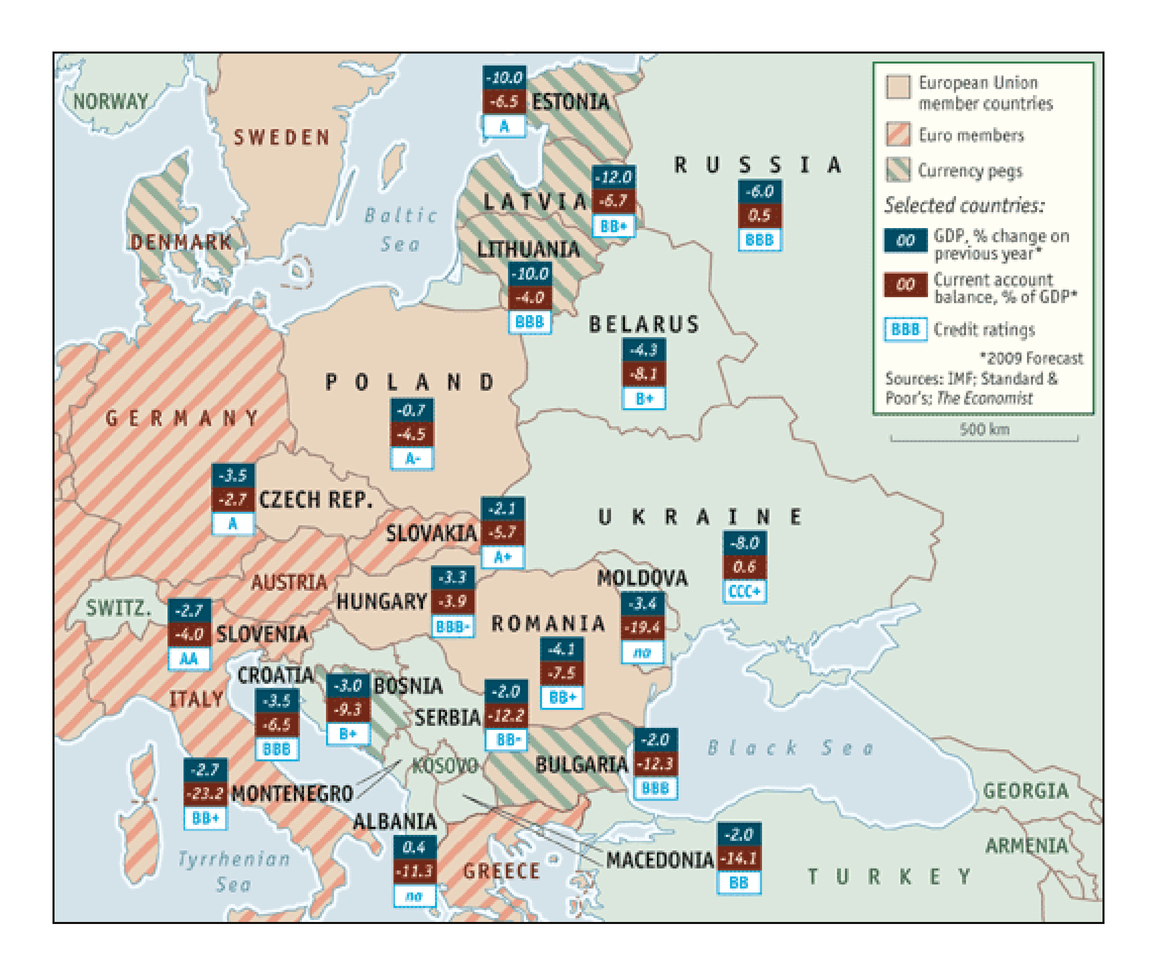
The next lot of statistics may show that South Africa has entered a recession after many years of fast growth. Mr Zuma will strive to retain investors' confidence. Much may depend on whether Mr Manuel, in his new job, really does have the authority Mr Zuma says he has bestowed on him. If so, the president may have time to enjoy his red-bush herbal infusions.

Central and Eastern Europe

No panic, just gloom

May 14th 2009
From The Economist print edition

The region as a whole may have avoided economic meltdown, but several countries still face a painful slump



THANKS to a mix of luck and good decisions, the economic apocalypse that loomed over central and eastern Europe seems to have been averted. But dizzy current-account deficits, wild foreign-currency borrowing and reckless fiscal policy are leaving a horrible hangover for some. The IMF forecasts a 4.9% average fall in GDP, with far bigger falls for some. The European Bank for Reconstruction and Development (EBRD) reckons on a 5.2% drop. The downturn is certainly nasty; but some changes have staved off the worst.

One change is that outsiders now assess risk more calmly and rationally. All the former planned economies remain capital-thirsty. But otherwise they are all different. Indeed, a rare common factor among 20-odd countries in the region with the "ex-communist" tag is that they dispute its relevance. Tarring all with the mistakes of overheated Latvia, chaotic Ukraine or debt-sodden Hungary makes no sense. Nor does lumping together rich and poor countries, or those in the European Union and those outside. Exchange-rate regimes vary: two countries are in the euro; five countries have pegged their currencies to it; others float.

So far at least, speculators who counted on contagion toppling countries like dominoes have little to show for it, while those who bet the other way have juicy gains. Poland's stockmarket is up by nearly 40% since its low in February, Hungary's has risen by half and Russia's by nearly 90%.

Outside help is also now better co-ordinated. The previously standoffish IMF co-operates with the European Commission, national governments and the banks. Once seen as a lender of last resort, it now

acts pre-emptively. In May it gave a $21 billion credit line to Poland, the biggest and strongest economy in the region. That is quite different, officials stress, from the emergency rescues of Belarus, Latvia, Hungary, Romania, Serbia and Ukraine.

The IMF is also behaving more gently. Ukraine was originally told to balance its budget this year. Now the IMF says a deficit of 4% of GDP is realistic; this month it released its latest $2.8 billion tranche. Officials are uneasy about insisting on fiscal tightening that may aggravate recession. Latvia is likely to be allowed to run a 7% deficit for this year—in return for promising, really and truly, to reach 4% in 2010.

A third change is that more aid has been given to western banks that face souring loans, typically to clients in Hungary and the Baltic states who borrowed in euros or Swiss francs. As outsiders cut back, a credit squeeze is threatening even healthy borrowers. A joint initiative by the EBRD, the World Bank and the European Investment Bank (which used to lend only to state-backed infrastructure projects) has raised $24.5 billion for banks and other firms across the region. The EBRD is putting €432m ($590m) into UniCredit, an Italian bank heavily exposed in eastern Europe. It is thinking of investing in 12 other west European banks. Countries such as Sweden have national schemes too.

In a new report, the IMF argues that European banks still need a lot more help. But the cash and guarantees given already have eased the greatest threat to the region: that western banks might pull out or sink under the weight of their eastern loan books. Meanwhile central Europe, home of many big car factories, has gained from rich-country governments' efforts to help their car industries. Neil Shearing of Capital Economics, a consultancy, reckons that German and other scrapping schemes to boost car sales will add fully 1% to GDP in Slovakia, and 0.5% in the Czech Republic and Hungary.

The biggest worry now is the Baltic three, which are seeing the sharpest falls in GDP. Estonia's first-quarter figures showed a year-on-year decline of 15.6%. The fall in Latvia was a stunning 18% and in Lithuania 12.6%. Monetary policy cannot counteract this, since all three are pegged to the euro. And fiscal policy offers no respite. Politicians are pushing through spending cuts, not only to reassure external lenders, but also to meet the Maastricht deficit target of 3% of GDP so as to adopt the euro soon (by 2011, Estonia hopes).

"The crisis is even good if it makes the state more efficient," says Andrus Ansip, the Estonian prime minister, who is cutting overall public spending by nearly 12%. He has slashed a fifth of the posts in his own chancellery, he says proudly. "Inefficient" spending will be cut; budgets vital for future growth will be preserved, he insists.

Devaluation is still largely taboo in the Baltics. The national currencies are not just economic symbols of solidity, but political ones too. Instead, they hope to regain competitiveness through wage cuts and greater efficiency. Such an "internal devaluation" is possible in theory, but it is unusual (and painful) in practice. It may work: Latvia now has a current-account surplus as its exports rise. Outsiders are awed by the Balts' determination, though sceptical that the sacrifice will pay off.

Still, while industries such as construction collapse, others, such as alternative energy, are growing. Mr Ansip cites Estonia's niche in windpower technology. In Latvia a firm called Carbon Neutral Biofuels has raised money for a $10m plant to turn low-grade wood into fuel pellets for Dutch power stations. Adrian Riley, the boss, says the crunch is "a return to reality after a period of acute silliness" when high costs threatened his project's viability.

The Baltics may be a special case: small, relatively well run, with flexible economies and friendly Nordic neighbours. The broader worry across the region is political. Street protests have been muted so far, and some anger against the smug, corrupt and incompetent politicians who squandered the chances of the past decade is anyway healthy. But the European elections in early June may show how voters are reacting to hard times.

Government crises have not brought big changes. The Czech Republic's centre-right coalition lost its majority in March amid a row with the headstrong president, Vaclav Klaus. But the result has not been chaos. Until elections in October, a competent-looking caretaker government will run the country, headed by the chief statistician, Jan Fischer. In Hungary a discredited Socialist prime minister, Ferenc Gyurcsany, resigned, nominating an economist, Gordon Bajnai, to run the government until an election next spring. He is pushing through tough spending cuts, with GDP likely to fall 6% this year.

Ivan Krastev, a Bulgarian-based analyst of the region's politics, says the fear of unemployment will disillusion middle-class voters and stoke protest voting. A bigger problem may be the fear among political elites, some of whom will stick at nothing to stay in power and out of jail. "The model is Berlusconi," he

says glumly.

Nazi war crimes

John Demjanjuk flies in

May 14th 2009 | BERLIN
From The Economist print edition

A fresh trial in Germany, 16 years after Israel quashed his death sentence

THE passenger touched down in an executive jet, but was whisked away in an ambulance to a Munich prison. Thus did John Demjanjuk arrive in Germany on May 12th to face charges that in 1943 he helped murder at least 29,000 Jews and others at the Sobibor death camp, in Poland. The trial of the 89-year-old former car-worker from Cleveland, Ohio, could be Germany's last showcase attempt to do justice for Nazi war crimes.

AP



From Cleveland to Munich, via Jerusalem

Some earlier trials were defining events. The "Auschwitz trials" of 1963-65, in which 17 functionaries were convicted, showed Germans that the perpetrators were living unobtrusively among them and helped inspire youth rebellions in the late 1960s. In western Germany alone since 1945, some 106,000 people have been investigated and 6,500 convicted for Nazi crimes. Germany's "demonstrative remorse" forged its identity as a country that acknowledges its crimes and is determined not to repeat them, says Devin Pendas of Boston College.

Even if doctors rule him fit, Mr Demjanjuk's trial may prove risky without being revelatory. It will not shed new light on the Holocaust. Young Germans neither wish to conceal the past nor share their parents' eagerness to lay it bare. Prosecutors risk seeming to torment a frail old man. In 1988 Mr Demjanjuk was sentenced to death by an Israeli court as "Ivan the Terrible", a sadistic guard at the Treblinka death camp. But Israel's Supreme Court overturned the verdict after new Soviet-era documents cast doubt on his identity; it said he had been a Nazi camp guard, but not Ivan the Terrible. A Ukrainian captured by the German army, Mr Demjanjuk twice gained and lost American citizenship. Now he may inspire sympathy as "a human wreck on the border between life and death", wrote one commentator.

German law sets a high bar for conviction. Genocide or crimes against humanity do not apply, because they were codified after the war. The statute of limitations has run out for those who merely carried out orders. Mr Demjanjuk will be tried as an accessory to murder, which requires proof that he killed willingly. Prosecutors have an identity card that seems to prove he was at Sobibor (perhaps a forgery, says the defence). But proving intent often requires evidence from eyewitnesses, who may be no healthier than the defendant. Germany can try a Ukrainian for crimes committed on Polish soil because it gave the orders and some victims were Germans, says Kurt Schrimm of the Central Office for the Investigation of Nazi Crimes. Liability for murder "does not expire". By trying Mr Demjanjuk Germany hopes to show that time has not blunted its zeal for an honest reckoning with the past.

French prisons

Still miserable

May 14th 2009 | PARIS
From The Economist print edition

Deteriorating conditions increase the pressure to improve French prisons

IN THE dead of night, an unusual convoy made its way through Lyon earlier this month. Escorted by 900 policemen and prison officers, with blue lights flashing and a helicopter overhead, 436 prisoners were transferred by road from two decrepit 19th-century inner-city jails to a brand-new facility in the suburbs. It was the biggest prisoner transfer ever conducted in France—and it reflects a belated effort to respond to dreadful prison conditions.

For years outsiders have pointed fingers at the deteriorating state of France's 194 prisons. In a 2006 report the Council of Europe's human-rights commissioner, Alvaro Gil-Robles, said that "some things I saw during my visit were deeply distressing and shocking." He pointed to chronic overcrowding, unsanitary cells, dirty lavatories, broken showers and mattresses on the ground. He described conditions in two prisons, La Santé in Paris and Les Baumettes in Marseilles, as "on the borderline of human dignity". Of a detention centre under the Palais de Justice in Paris he commented to *Libération*, a newspaper: "In all my life, except perhaps in Moldova, I have never seen a worse centre than that."

The main problem is that France's prison population has grown faster than its available cells. The number of inmates has jumped by 30% since 2000 to over 63,000, against a capacity of only 51,000. Most of the growth stems from harsher sentencing. In 2007 President Nicolas Sarkozy, himself a former interior minister, introduced minimum sentences for repeat offenders. Certain crimes, such as domestic violence, are now more likely to lead to prison terms. And prisons house a disproportionate number of the mentally ill; a study suggests they make up 20% of inmates.

Trade unions say that overcrowding puts both prisoners' and prison officers' safety at risk. Prison officers, who are not allowed to strike, recently blockaded jails around the country. Riot police had to be sent in to control protests outside certain prisons, notably Fleury-Mérogis, France's biggest. After talks with Rachida Dati, the justice minister, the unions signed a deal this week, securing better working conditions and the creation of an extra 351 jobs.

A big renewal programme is also under way. The government is building new prisons and revamping old ones to bring them up to European norms. It is now policy to separate the quarter of all inmates awaiting trial from those already sentenced. The use of electronic tags should also put fewer pre-trial suspects behind bars. Twenty new jails are to be opened by 2012, and 13 old ones shut. A new law to improve the rights and conditions of prisoners and prison officers is in the works. The government has also appointed France's first independent inspector of prisons, Jean-Marie Delarue.

Prison reformers think the government needs to do more than just reduce overcrowding. France may be the birthplace of human rights, but people still think prisoners should pay for their crimes with more than their liberty. Day-time activities and exercise facilities in jails are often minimal, as are conditions for family visits. Work and training opportunities are limited. Although over half the prison population is said to be Muslim, there are few Islamic prison chaplains. In his first report Mr Delarue refers to "a deeply rooted conviction on the part of public opinion that poor conditions of existence for inmates are a 'just' return for the offence committed."

The upshot is boredom, tension, depression and worse. Some 115 prisoners committed suicide in French prisons in 2008, a 20% increase on 2007. And in the first quarter of this year alone, according to France's International Prison Observatory, a civil-liberties group, another 36 inmates took their own lives.

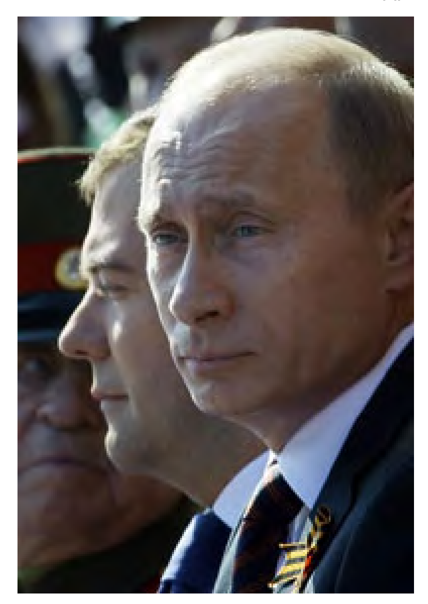
Russia and its image

Put in more flags

May 14th 2009 | MOSCOW
From The Economist print edition

What military parades and song contests say about Russia's future

AP



Putin and Medvedev, power couple

AMID Russia's anti-crisis measures, the military parade on Red Square on May 9th was spectacular. Some 9,000 soldiers goose-stepped past political leaders. Tanks, rocket launchers and ballistic-missile carriers scratched the cobblestones; bombers, jets and helicopters flew above St Basil's Cathedral. The show is meant to mark victory in the second world war. But this genuinely national holiday has long been appropriated by the Kremlin for ideological ends. Rather than celebrating the war's end, this military parade represented Russia's readiness for a new fight.

President Dmitry Medvedev affirmed in his address that the lessons of the war against the Nazis were "relevant today, given the outsiders who are interested in embarking on military adventures." And, making the reference to Georgia even more explicit, he added that "among the descendants of war heroes marching in the square are those who in actual battle have demonstrated the great fighting efficiency of the modern Russian army."

There was no room in the celebrations to mention Russia's wartime allies or to re-examine Stalin's destructive war strategy. "The country that won the war has disappeared, self-destructed," Viktor Astafyev, a late Russian writer and war veteran once wrote in a letter. "The more you lie about the past war, the quicker you bring about the next one," he declared in another.

On his video-blog Mr Medvedev hit out at attempts to falsify history by former Soviet republics. Anyone who questions the official version of Russia's victory or talks of Soviet occupation may soon face criminal charges in Russia. The Kremlin has massively rewritten history, approving textbooks that rehabilitate Stalin as an "effective manager." And it often turns a blind eye to the fascist talk of ultra-nationalists.

At a time of financial crisis, this posturing is meant not only to project Russian invincibility but also to compensate for falling incomes and rising unemployment. To maximise the therapeutic value of the parade it was preceded by full-scale public rehearsals that won top billing in news bulletins. That some 100,000 Russian war veterans do not even have flats took second place to a show that cost an estimated 3 billion roubles ($94m), half of it for patching up the road surfaces it damaged.

Nor is Russia economising on another flag-waving event, the Eurovision song contest, which it is hosting. The coincidence of the two shows exemplifies the glitzy entertainment and sabre-rattling that are so close in Kremlin ideology. Konstantin Ernst, who commands Russia's main state TV channel and is in charge of Eurovision, said it was the "external political effect" that mattered. The impact was heightened when Vladimir Putin, the prime minister, came fresh from the victory parade to the Olympic arena on May 9th to check up on preparations for the song contest. In the past Kremlinologists monitored Soviet leaders by their line-up above Lenin's mausoleum. Now it is by their appearance at Eurovision.

After a year of Mr Medvedev's presidency, a third of Russians feel that Mr Putin is still in charge; only 12% believe that Mr Medvedev has supreme power. In an interview with the Japanese media ahead of his visit there, Mr Putin did not duck the question of who might be Russia's next president. "President Medvedev and I will decide what we will do, depending on the results of our work," he said, adding that Mr Medvedev was a "very honourable man who would consider his political future according to the country's interests." This suggests that Mr Putin expects his protégé to honour whatever agreement they have reached. A popular vote does not seem to feature in the process.

Mr Putin's comments have reinforced expectations that he will return as president (for two six-year terms)

when Mr Medvedev's term expires in 2012. As for Mr Medvedev, the Moscow rumour mill says he may fancy becoming boss of the constitutional court, a job that also falls vacant in 2012. Mr Medvedev recently suggested that the next head of the court should be chosen by the president. As a top lawyer, he would be in a position to ensure that none of Russia's recent history was falsified.

Immigration in Italy

A mess in the Mediterranean

May 14th 2009 | ROME
From The Economist print edition

Italy grapples with the size and impact of illegal immigration

IMMIGRANTS arriving by sea from Africa have become a painful thorn in the side of Silvio Berlusconi's government. It was elected after pledging to stem "clandestine immigration"—hardly an appropriate phrase in these cases, since the hope of desperate passengers aboard unsafe boats from Libya is precisely to be rescued. Once on Italian soil, the migrants may seek asylum. The two-thirds who do not win any protection are meant to be repatriated. But because most arrive without papers, the authorities have no idea where they are from. So they join the cohorts of immigrants living in Italy without permission. And since they cannot legally get a job, it is not surprising that they are charged with a disproportionate amount of crime—which the government was also elected to curb.

This week Italian sailors were due to join their Libyan counterparts in patrols of Libya's coastline, opening the latest phase in a drive by the government to shut off this perilous route into the European Union. By then, however, the measures the government had already taken had put it at loggerheads with a host of international organisations, including the United Nations. They have also divided both Mr Berlusconi's supporters and his opponents.

A week ago, an Italian naval vessel intercepted three boats full of migrants. Instead of taking the people aboard to Italy, it returned them to Libya. Their acceptance there was a turning point, representing the fruit of 12 months of quiet diplomacy aimed at getting Libya's leader, Muammar Qaddafi, to co-operate. Yet the rejoicing in Rome did not last long. The government was attacked for failing to give the returned migrants a chance to seek asylum. The UN's high commissioner for refugees, António Guterres, expressed "grave concern". He was backed by the secretary-general, Ban Ki-moon. The new policy was censured by the Council of Europe, by some NGOs and, more surprisingly, by a man who is meant to be Mr Berlusconi's main ally: Gianfranco Fini, founder of the National Alliance, the junior partner in Mr Berlusconi's coalition.

Equally surprising, the forcible returns (of more than 500 people, so far) have won plaudits from several on the centre-left who accept the government's protest that it is legally entitled to turn back immigrants so long as they are outside Italian territorial waters. Some noted that a centre-left government had similarly blockaded Albania's ports in the 1990s. "Italy seems to be trying to rewrite international refugee law," said Bill Frelick of Human Rights Watch. "The 1951 Geneva convention does not say where you can return them from, but where you can—and cannot—return them to." It commits signatories, including Italy, not to send a refugee to "territories where his life or freedom would be threatened". HRW says it has evidence of migrants returning to Libya being put in indefinite detention, where some have been mistreated. Other countries question whether a refugee acquires the right not to be returned when still on the high seas, notably America, which often turns back vessels in the Caribbean.

Mr Berlusconi's credibility suffers when he gives the impression of being anti-immigrant. This week the lower house passed a bill proposing stiff fines for immigrants without papers and high charges for residency permits. On May 9th Mr Berlusconi criticised the very notion of a multi-ethnic Italy. Opposition politicians and some bishops said it was a bit late for aspirations to racial purity. Caritas, a Catholic charity, says immigrants make up 7% of Italy's population. Mr Berlusconi's remark was apparently aimed at winning far-right voters before the European election. The danger is that many a racist thug may now think he has tacit support from the prime minister.

Greece and immigration

Fear and loathing in Athens

May 14th 2009 | ATHENS
From The Economist print edition

Once hospitable Greeks are turning against immigrants

THE ancient Greek tradition of hospitality to strangers is dying out. Twenty years ago Greeks welcomed more than 600,000 Albanians who walked over the border to start a new life. These days Albanian families have credit cards, mortgages and residency permits. Smaller numbers of Bulgarians, Romanians, Moldovans, Ukrainians, Georgians and Russians also have a toehold in Greece. But a new wave of immigrants from places like Pakistan, Afghanistan, Iraq, Sudan and Somalia has met indifference or even outright hostility.

On May 9th far-right protesters tried to storm a former court building in Athens that is a squalid home for 600 immigrants. One resident, Moncef, a mechanic from Morocco, says: “The police stood there and did nothing.” It took a group of Greek anarchists to come to the rescue. More than a dozen policemen were injured and four protesters were arrested—but the immigrants stayed.

AFP



A court can be a home for some

Their numbers keep growing. Last year more than 146,000 illegal immigrants arrived, mostly via Turkey, up from 100,000 in 2007. Most end up in Athens because the Turks no longer respect a bilateral agreement to return illegal immigrants, say Greek officials. The half-dozen reception facilities on the Greek islands are overwhelmed; desperate local officials resort to handing out free tickets for the ferry to Piraeus.

The government’s policy is to discourage immigrants from staying. In 2005 it stopped issuing temporary permits allowing immigrants to work, pay social-security contributions and, eventually, become legal residents. Those found without papers are detained for three months, then told to leave the country within four weeks. Last year 88,000 exit orders were issued; but only 18,000 people left.

Those who seek asylum also receive short shrift. In 2008 less than 1% of applicants were granted refugee status immediately, although 11% of those who appealed were successful. Thomas Hemmerberger, a Council of Europe human-rights official, has accused Greece of failing to live up to its responsibilities to protect asylum-seekers.

Thanos Kourkoulis of Greece’s Anti-Racism Movement, who runs a school where volunteers teach Greek to immigrants, says tensions are rising. “Immigrants feel more intimidated, Greeks feel more at risk,” he says. Human-rights groups and local residents oppose plans to use an old military base outside Athens as a detention centre. Yet the flow of arrivals shows no sign of slowing.

Charlemagne

Bulgarian rhapsody

May 14th 2009
From The Economist print edition

Why the European Commission imposed sanctions on its poorest Balkan member

Illustration by Peter Schrank



FOR a man facing the threat of bankruptcy in six months' time, thanks to European Union sanctions on his country, Stefan Petrov has pretty warm words for Brussels. Mr Petrov is a dairy farmer from the rolling hills of northern Bulgaria. Two-and-a-half years after his country joined the EU, his business is in peril after €800m ($1.1 billion) in transitional aid for new members, including farm aid, was frozen by the European Commission last year, amid complaints about fraud, contract-padding and conflicts of interest. About €220m of the frozen money has been lost for ever, after a deadline for spending the cash expired in November. The pot of €110m that includes Mr Petrov's grant is due to expire at the end of this year. Yet the farmer does not quarrel with the logic of the decision to freeze Bulgaria's aid, which is the toughest sanction ever imposed on any EU member. "Those who govern us tried to steal the funds, and partly succeeded," says Mr Petrov, when asked why the European money was blocked. The EU, he insists, is "good for farmers".

To meet European standards, Mr Petrov had to connect his cowsheds to the water mains. He has just installed a gleaming new Swedish milking parlour, replacing an old system of pipes and pumps that, to the amateur eye, seemed to be held together by rust and cobwebs. He had an EU grant equivalent to €50,000 approved last autumn. That was why a local bank lent him money with minimal fuss, even though he had to put up his four cowsheds—large barns from an old collective farm, filled with twittering swallows and the sweet smell of dung—as collateral. A former trolley-bus driver under communism, he started with one cow in 1991 and now has 230, making him one of the biggest farmers in his district, near Pleven. His EU grant application included a chunk of money for a new, Czech-built tractor, to increase his business's profitability.

The tractor is already roaring about the farmyard, but the EU money is another story. The grant awarded to Mr Petrov comes from a special pot of transitional farm aid, known as SAPARD funds. The Bulgarian government says it has fixed problems identified by the EU, and will pay urgent grants out of national coffers. Gloomy European officials say Bulgaria still seems in no hurry to fix the problem, as different ministries squabble and continue to protect cronies. Mr Petrov was expecting his grant two months ago. With milk prices low at the moment, he thinks he can make loan interest payments for another six months, then he will go under. Yet he still declares: "Our hope is with Europe."

His views are widely shared. Most Bulgarian voters tell pollsters they trust EU institutions. As many as

three-quarters say they distrust their national parliament and government. But will Bulgarian tolerance last if funds remain frozen much longer or if other bits of EU funding have to be frozen in the future? It is a question which resonates far beyond Bulgaria.

Plenty of diplomats and politicians in Brussels say that Romania and Bulgaria were admitted too soon, arguing that once such countries get into the club, the EU loses most of its leverage over them. (Many say much the same of Cyprus as well.) The counter-argument is that admitting countries like Romania and Bulgaria is the best way to protect and encourage internal reformists who are the best hope for the future.

Either way, what is clear is that the decision by the European Commission to freeze funds for Bulgaria was not just a technical measure. It was a deeply political experiment—nothing less than an attempt to claw back leverage over governments after they entered the union. The success of the experiment matters. The next countries hoping to join the EU mostly come from the Balkans, and many will display the same problems as Bulgaria and Romania in even more extreme form. If the EU can use the tough love of frozen funds in Bulgaria and yet still maintain voter support, that will be a boost not only to reformers in that country, but also to the whole cause of future enlargement. If, on the other hand, EU sanctions trigger a backlash against Europe in Bulgaria, the commission's experiment could turn out less well.

When sanctions work

The fate of EU funds has become a big political issue in Bulgaria, which will hold a general election in July, a month after the election of a new European Parliament. Although the current Socialist-led government trumpeted the release of €115m in EU road cash on May 12th, much more money remains frozen. Opposition leaders such as Boyko Borisov—an ex-wrestler and police chief who now serves as mayor of Sofia—say that government corruption gave Brussels "no choice" but to impose sanctions. Mr Borisov, whose party leads in the polls, offers few concrete plans for cleaning up the system, but he makes such stirring promises as "we will do what it takes for Europe to approve of us." Mr Borisov also notes the "paradox" that Bulgarians' trust in European institutions "actually increased when the money was frozen".

Back on the farm, Mr Petrov signals that his patience is not infinite. The freezing of EU funds was the "right" sanction, he admits. But the EU should think of another way of delivering money, he says, bypassing the government in Sofia if need be. A local mayor says 50 of his neighbours are in the same boat at Mr Petrov. The road to the nearest town was going to be fixed with funds that are now frozen, the mayor adds: yet locals still trust the EU.

The next wave of EU spending planned for Bulgaria adds up to more than €10 billion. If that money flows smoothly, EU popularity should not be a problem. But if Bulgarian corruption forces Brussels to freeze even bigger sums, plausible political consequences could range from a reformist revolution to a slide into nationalism. EU enlargement was always something of an experiment: it may be poised to enter uncharted territory.

Economist.com/blogs/charlemagne

Political expenses scandal

The great shaming of Parliament

May 14th 2009
From The Economist print edition

It has taken an almighty crisis for MPs to start cleaning up their act

Illustration by David Simonds



POLITICIANS who were dreading the day when their exploitation of Parliament's lax expenses regime would be exposed may have consoled themselves that at least it would all be over in one go. Hundreds of thousands of mortifying pages detailing their claims since 2004 were scheduled for official publication this summer, despite the tenacious resistance of parliamentary authorities in the courts.

In the end, though, the revelations came in agonising stages. The *Daily Telegraph* obtained the leaked data and, on May 8th, began to publish it. The first to be exposed were ministers. Another batch of Labour politicians followed before the spotlight shone on front- and backbenchers of the Conservative Party. By the time the Liberal Democrats' turn came round on May 13th, Parliament was on its knees.

The purchases dubiously claimed by MPs ranged from dog food and toilet brushes to thousands of pounds' worth of home improvements. Much of the nest-feathering took place under the so-called second-homes allowance, worth up to £24,000 ($36,000) a year to MPs who require accommodation in both London and their constituencies. Some "flipped" the designation of their first and second homes in order to be reimbursed for work done on both. A few profited by sprucing up a second home on expenses before reclassifying it as their main residence to avoid capital-gains tax when they sold it.

The reaction of politicians to the great exposure has only slowly and fitfully begun to match public outrage. Gordon Brown apologised for the entire political class on May 11th. David Cameron, the Tory leader, and the Lib Dems' Nick Clegg followed suit, declaring that colleagues would pay back unjustified claims. Andrew MacKay, Mr Cameron's parliamentary aide, has resigned over claims his party deemed "unacceptable"; some MPs are returning money; pressure on Michael Martin, accused of an indulgent line on expenses as speaker of the House of Commons, is growing; and reform of the system is now inevitable. An inquiry by the independent Committee on Standards in Public Life, launched after previous scandals, is due to report this year.

But all this came after days of mealy-mouthed denial and obfuscation. Some MPs blamed the media (the *Telegraph* is said to have paid for what could be regarded as stolen information). Others insisted the controversial claims were technically within the rules, as if those rules were not made by Parliament itself, and as if their spirit did not matter as much as their letter.

Voters, forced by recession to live more leanly, are irate. A Populus poll conducted as the Labour and Tory revelations were being published showed the two parties down by four percentage points each, while the Lib Dems, yet to be exposed, were up by four. And 86% of respondents thought all the parties equally bad on expenses. Britain's anti-politics mood did not need the boost that the expenses scandal has given it. In April a YouGov poll showed that a third of voters trusted no politician to tell the truth (Mr Brown and Mr Cameron were trusted by only 12% and 21%, respectively, of respondents).

Yet the perverse result of all parties being tainted may be that no party really is. The incumbents are culpable for letting a bad system fester for so long, and Mr Cameron produced a better and bolder response than Mr Brown. But the spectacle of wealthy grandees having their country homes renovated at taxpayers' expense has done the Tory brand no favours. And the Lib Dems cannot afford to lose their unique selling point as Westminster's nice guys. Labour, one of whose MPs is responsible for what is perhaps the gravest offence (Elliot Morley claimed £16,000 for a mortgage he had already paid and was suspended from the Parliamentary Labour Party on May 14th), looks the worst, by a bit. But just as the sleaze that racked the last Tory government only amplified the defeat they were already due to suffer in 1997, so this scandal only reinforces the likely outcome of the next election: a loss for Labour, and grudging approval for the Tories.

Amid the din of recrimination, some MPs' plaintive wails deserve to be heard. British politicians are neither corrupt nor lavishly remunerated by international standards. The revelations were less shocking than many observers expected. Some MPs have shown Cromwellian rectitude; the cynic's mantra that they are all bad is nonsense. And while much of Britain's anti-political mood is a justified response to a scandal for which MPs must do penance, some reflects a basic nihilism they can do little about. A popular television satire, "The Thick of It" (and its recent film adaptation, "In the Loop", with its prescient gag about a politician expensing porn films), is funny viewing but its central conceit that everyone in politics is stupid and malign is all too widely held.

The expenses scandal was born of two traits often found in British public life: a preference for "muddling through" over rational design, and a reluctance to ditch a flawed system until it falls apart in a crisis. As MPs' earnings fell over time behind those of bankers and family doctors, and as their role changed to include constituency work better done by local councillors, they could have debated, openly and from first principles, the issue of pay and expenses. But rather than risk honest analysis of what MPs are for and what they are worth, they improvised a solution by treating expenses as a way of topping up their income. And instead of abandoning this approach when its flaws came to light—mini-sleaze stories have abounded in recent years—they procrastinated until a crushing torrent of revelations pushed them into action. The failure to act sooner will damage their reputations for years.

The Bank of England's prognosis

Don't get your hopes up

May 14th 2009
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Despite signs of improvement the economy still needs intensive care

THE Bank of England's austere home in Threadneedle Street may not look like a hospital but for the past few months it has been acting like one. As the economic downturn became a full-blown collapse late last year, the central bank's senior consultants—its monetary-policy committee—donned their white coats and got to work.

First they put their scalpel to interest rates, slicing them from 5% in early October to an all-time low of 0.5% in March. Not content with that, they switched at once from scalpel to syringe and started to inject money into the economy through "quantitative easing"—buying assets with freshly created central-bank money.

As with the preceding rate cuts, the new treatment has been administered in uncompromisingly big doses. Twice, the Bank of England has surprised the markets with the ambition of its planned purchases. The initial goal it set in March of buying £75 billion ($114 billion) of assets, predominantly gilts held by investors such as insurance companies, was well above expectations. The bank's decision on May 7th to raise that objective to £125 billion, to be completed in three months' time, was also more than predicted.

So is the emergency treatment working? There have been some encouraging signs over the past couple of months. The stockmarket has rallied sharply as investors have regained their nerve and fears about banks going bust have receded. Surveys of businesses and consumers have also picked up, as sentiment has become less negative. High-street sales surged in the year to April (though warmer weather and the timing of Easter exaggerated the growth) and estate agents reported another rise in inquiries from new buyers. With an index of leading indicators for the British economy compiled by the OECD now starting to edge up, hopes are rising that the worst of the recession may be over.

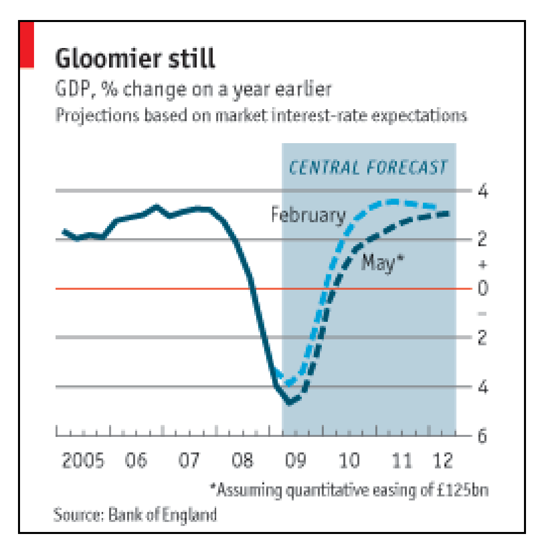
That may be premature, given the pain shown in the latest labour-market figures. The number of jobless looking for work jumped by 244,000 between the last three months of 2008 and the first three of 2009, the biggest rise since 1981. That pushed unemployment up to 2.2m and the jobless rate up from 6.3% to 7.1%, making predictions of eventual peaks of 3m and 10% look increasingly plausible. In another sign of weakness, average earnings fell by 0.4% compared with their level a year ago—the first ever decline in figures going back to 1964, though this was largely because bankers received lower bonuses.

The Bank of England doused much of the rekindled optimism about economic prospects when it presented its quarterly *Inflation Report* on May 13th. This was even gloomier than the bank's forecast three months ago (see chart). The new central projection implies that GDP will drop this year by around 4%, compared with 3% in February, and will grow by 1% in 2010 rather than the 2.3% previously predicted.

Despite this unprepossessing outlook, the bank envisages a recovery starting by the end of the year. It will spring from three main sources. First, the economy will be boosted by what Mervyn King, the bank's governor, describes as an "unprecedented policy stimulus, both monetary and fiscal". Second, the big depreciation in sterling will help by supporting exports and constraining imports. And third, the inventory cycle will turn round as producers start to satisfy demand by raising output rather than running down stocks.

All this should lead to a rebound, but Mr King says that a sustainable recovery is far from assured. Unlike previous post-war cycles, any upturn will follow a global financial crisis. Set against the forces pulling the economy up will be the continuing downward drag from households and companies wanting to pay down debt,

and from banks behaving far more cautiously than before. As a result the recovery is likely to be “relatively slow and protracted”.



That will leave the patient in a critical condition for some time to come. Although the central bank has become less worried about deflation, its central forecast shows consumer-price inflation, currently 2.9%, falling below 1% later this year and staying below the 2% target over the forecast horizon. This suggests that the markets have got it wrong in anticipating rate increases in 2010. With the economy remaining frail, the base rate looks set to stay at 0.5% for a long time.

The Bank of England will provide additional help through its policy of quantitative easing. Mr King explained that the bank had decided to expand the programme of asset purchases because more needed to be done to boost the supply of broad money. Just how effective the policy will prove cannot yet be judged. The most obvious impact was at the outset of the programme in March when yields on benchmark ten-year gilts fell sharply, but since then they have gone back up again. Even so John Wraith, a gilts analyst at Royal Bank of Canada, thinks that yields would be up to half a percentage point higher if the central bank had not started to buy government securities.

The Bank of England has delivered a sombre warning. A swift return to rude economic health is highly unlikely after the financial and economic convulsions of the past two years. A prolonged convalescence is the best that can be expected.

Immigration and agriculture

No rural idyll

May 14th 2009 | EVESHAM
From The Economist print edition

Migrants in the countryside get a raw deal—but that may be changing

THE Waterside Hotel looks a heavenly spot for a stay, overlooking the river Avon in a quiet part of Worcestershire. But tourists are out of luck: the entire hotel has been bought by Kanes Foods, a packing firm, to lodge some of its 600-strong foreign workforce. Other employers have resorted to less salubrious solutions. The fields around Evesham, an ancient market town with blessedly lush soil, are dotted with caravans and Portakabins, housing workers who pick and pack everything from asparagus to peas and cabbages.

Conditions inside some of those caravans are bad. A forthcoming report from the Institute for Public Policy Research (IPPR), a think-tank, cites examples of workers living without running water and lavatories, sleeping in shipping containers. Laws against inadequate quarters do not always cover such dwellings, and responsibility for inspecting them falls on the same local councils that would have to re-house their tenants. The authors want the government to consider building workers' hostels, as other countries have done.

Why should the lot of rural workers be so miserable? Partly it is the nature of low-paid, scattered agricultural work, which means that labourers are often housed and bused around by the same people who employ them. A poll of Poles living in rural areas by IPPR found that 23% were in "tied" accommodation, provided by their employer or the gangmaster who recruited them and often substandard. English lessons, which might open other doors to them, require minimum class sizes and are hard to provide out in the sticks.

Some rural areas are simply unused to migration, and this has made things harder. Evesham's Catholic school has just hired a Polish-speaking assistant. Across the county, the number of pupils whose first language is not English has risen by 56% since 2003, and it has doubled in Cumbria and the Isle of Wight. The police have hit language problems too (though not as badly as in Ireland, where coppers belatedly realised that a certain Mr Prawo Jazdy, wanted for more than 50 traffic violations, was in fact Polish for "driving licence").

The reason for many such hiccups is that rural immigration has until now gone relatively unnoticed. Councils have long complained that official measures undercount their migrants, by not including those living at business addresses, such as farms, or those staying in Britain for less than a year, as many seasonal workers do. That means councils get less money from the central government than they ought to. Charities which focus on migrants tend to neglect the countryside too, partly because they are more interested in refugees, who tend to be city-based. And the transient nature of seasonal working means that the migrants themselves have failed to organise. The Poles who came to Evesham after the second world war set up a social club; the new wave hasn't bothered yet.

Report Digital



Some corner of a foreign field

That might be about to change, however. For one thing, some of the new European workers are here to stay: despite the recession, a third say they plan to remain for at least five years, the IPPR found, perhaps because the Polish economy has tanked too. In Evesham Piotr Lisowski, an engineer at Kanes, has just bought a house; he and his wife have decided that Britain is a better base for their new baby than Poland. Chris Brooks, whose time as regeneration manager on the local council is increasingly absorbed by Polish affairs, is helping to set up a Polish association, which he hopes will make it easier to transmit advice about housing, laws and the like. Migrants have not placed a big strain on services by force of numbers, he says; the main problem is simply not understanding the rules, which makes work for the police tackling uninsured driving, for example, and for emergency wards when people go there rather than to their GP.

The large migration of eastern Europeans to the countryside has also focused attention on the role of gangmasters, and seemingly improved their operations in the process. The Gangmasters Licensing Authority (GLA), a statutory watchdog, was set up in 2005 following the drowning of 21 Chinese cockle-pickers led into dangerous waters by their boss. In order to get a licence, gangmasters must now submit to a series of agreements designed to protect their workers. Mark Boleat, who chairs the Association of Labour Providers, an industry body, argues that red tape has sometimes worsened conditions: no employer may charge his workers more than £31 ($47) a week for accommodation if they are on the minimum wage, for instance, which Mr Boleat says keeps the standard of housing low. But most acknowledge that the GLA itself is a good thing. More significantly, as large numbers of workers flock from eastern Europe of their own accord, farmers are less reliant on gangmasters anyway.

If local residents view migrant workers with a certain reserve, it is because they are competing for housing, not jobs. Few British workers fancy showing up for a 6am shift in one of Evesham's refrigerated food-packing factories, whatever the wage on offer. But more demand for rental accommodation has cut the supply of houses for sale to first-time buyers. "The local paper used to have ten pages of buying and one page of letting. Now it's the opposite," says Alan Booth, the mayor of Evesham. And some think migrants are moving into social housing too, a fear that the right-wing British National Party will play up; in February it won a local-government seat in Kent, another county with lots of rural migrant workers. The BNP plans to field candidates in the local elections next month. But Mr Booth suspects that soon Evesham will see Polish candidates too.

Saving the British pub

A murky tale

May 14th 2009
From The Economist print edition

Why some publicans have sorrows of their own to drown

Rex Features



PETER LUFF, a Conservative MP, is determined to correct a mistake he contributed to in 1989. In that year Parliament, on advice from the Monopolies and Mergers Commission (MMC), introduced the Beer Orders, aimed at curbing the power big brewers had through their ownership of public houses and control over the beer sold in them. Chastened brewers were forced to sell thousands of pubs. But the vacuum was soon filled by pub companies (pubcos), two of which, Punch Taverns and Enterprise Inns, today own around 7,500 public houses each. The companies exercise considerable power over publicans' lives through tenancies tied to the sale of specified volumes of beer and often other offerings too, such as food and gaming machines. Although the Beer Orders were revoked in 2003, and a parliamentary committee recommended new codes for pubcos a year later, not much has changed, says Mr Luff.

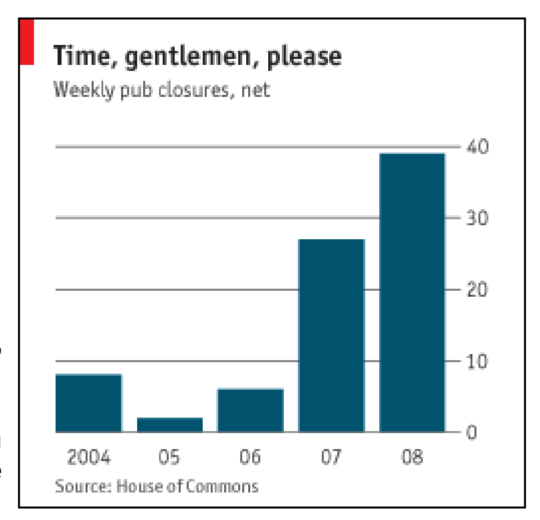
Now he hopes a new report on pubcos by the House of Commons' committee on business and enterprise, which he chairs, will trigger remedies for that "cock-up" 20 years ago. It criticises the pubco business model, particularly the relationship with tied tenants, which contain "inequalities of bargaining power". Giving tenants the option to untie their leases is one way of remedying matters. The committee wants the issue referred to the MMC's successor, the Competition Commission.

The pubcos, which account for about half of Britain's 57,000 pubs, are naturally indignant. They say the tied-tenant relationship has been investigated many times at both national and European level and found acceptable. In fact, it provides poorer would-be publicans with an entry into the business. The pubcos share the profit from high beer sales, but also some of the pain if sales are low, they claim. Punch Taverns has been helping its tenants with rent reductions to the tune of £20m a year, says Giles Thorley, its chief executive.

But the picture painted by the committee's anecdotal survey of tied tenants and lessees is rather different. Rent-setting is not always transparent, rent reductions can bring added burdens and wholesale beer prices are higher than those untied publicans pay brewers. All just as Dickensian, it seems, as in the days before brewers were limited to owning 2,000 pubs apiece.

This criticism of pubcos comes at a time when 39 public houses a week are closing (see chart), as recession and cut-price beer in supermarkets thin their business. It is not just tenanted pubs that are vanishing: more than half of the pubs boarded up in the first half of 2008 were owned by their managers. Some flourish: JD Wetherspoon, for example, a company that runs about 700 of its own managed pubs, continues to open new ones—35 are planned this year. But Wetherspoon is exceptional. It favours large beer halls in city centres, selling cheap food and ale for as little as 99p a pint. The pubcos Punch Taverns and Enterprise Inns are having to sell pubs, partly to service huge piles of debt.

The decline of the pub is causing concern in more quarters than corporate suites, however, for public houses have long been part of the fabric of the community. Their position should be shored up, says a new report from the Institute for Public Policy Research, a think-tank, through planning policy, lower business rates, grants and perhaps letting them double up as general stores and post offices. The few pubs that foster riotous behaviour and crime, mainly in inner cities, and invite heavy policing and regulation should not damn the many.



But to develop any future policy that might let pubs and publicans flourish it seems the biggest deficit is good data: on tied tenancies, how rents are fixed and terminated, how beer is priced and just how far discounts benefit the customer. All this could, and should, be examined by the Competition Commission with full co-operation by the pubcos—a willingness to oblige that was sadly lacking in the evidence they gave to Mr Luff's committee.

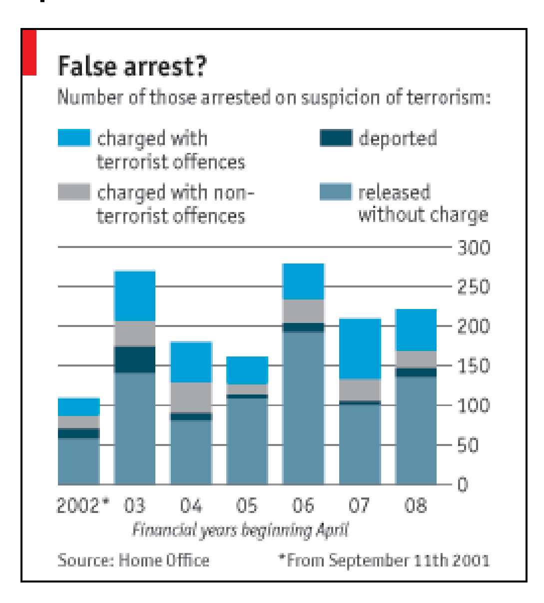


Fighting terrorism

Into the open

May 14th 2009
From The Economist print edition

New information sheds light on how the police are using their powers



BLISSFULLY blather-free, a report was released by Home Office statisticians on May 13th before any spin-doctor had been given a chance to fiddle with it. The bulletin tracked the outcomes of the 1,471 arrests of suspected terrorists made in Britain between September 2001, when fighting terrorism became a big part of police work, and April 2008, providing for the first time an overview of what is happening to those detained. Published under a new code of practice for official statistics, drawn up last year after ministers were caught massaging figures on knife crime, the report was pure, sober joy: long may the rule of the nerds continue.

Charges were brought against 35% of the suspects, which is roughly in line with other indictable (that is, serious) offences, according to the Home Office. A further 9% were dealt with in some other way: most of them deported and a handful sectioned under mental-health laws. The rest were freed without charge.

Encouragingly, 80% of those who were freed were released within just two days, and only three people were held for more than two weeks before walking free. Nonetheless, the numbers are enough to make anyone pause before considering extending the power to detain without charge, as the government proposed last year: 142 people were locked up for more than 48 hours before being freed without charge, among them racking up more than 800 days behind bars.

The report also showed that 181 people arrested on suspicion of terrorism were then charged with something else. This figure was previously unknown, because data on arrests are kept on a separate database (in the Home Office) from the data on charges and trials (in the Ministry of Justice). Boffins “did the whole job by hand”, says Paul Wiles, the Home Office’s chief scientific adviser. Some of those arrested were charged with serious offences—possessing guns or money laundering, for instance—and others with trivial ones, such as driving and drugs violations. But observers will note that a lot of non-terrorism charges have been brought using powers drafted to deal with terrorist threats.

A final curiosity is the ethnic breakdown of those detained in connection with suspected terrorism. South Asians made up 42% of the total, perhaps not surprisingly as they account for the bulk of Britain’s Muslims. But they were less likely than any other ethnic group to face charges following arrest. This sounds like an advantage, but it may imply just the opposite: that police arrest Asians on flimsier grounds than they do others.

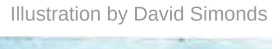
There is lots more to be mined from the statistics, which will be updated quarterly from the autumn. But the main conclusion is that the government should never have proposed extending counter-terrorism powers last year before conducting such a basic analysis as this of the current ones.

Measuring energy use

Knowledge is power

May 14th 2009
From The Economist print edition

Clever meters could cut energy consumption—and prices



THE utility meter's native habitat is the understairs cupboard, behind the ironing board and the Christmas decorations, covered in dust and playing host to a colony of spiders. From time to time a man turns up, peers at it and jots down numbers that somehow determine one's bill.

But the government has big plans for the humble electricity and gas meter. On May 11th it announced a consultation on a £7 billion plan to fit all 25m households in the country with compulsory "smart meters" by 2020, paid for by firms (and, by extension, their customers). Ed Miliband, the climate-change secretary, promised big cuts in energy use and carbon emissions.

Rather than simply recording energy consumption, smart meters send a continuous flow of consumption and billing data back to utility firms. And instead of an out-of-the-way read-out showing technical units such as kilowatt-hours, a prominent display reveals just how much money it costs to run a household-full of appliances.

It is these displays that ministers hope will cut power consumption and emissions. Consumers find it hard to measure how much energy they use, says Jonathan Stearn of Consumer Focus, a customer champion. Making people aware of the cost of leaving the lights on should encourage frugality. Energy use per household is already falling (see chart), partly because of higher prices. But the evidence from smart-meter trials in other countries is mixed, according to Sarah Darby, a researcher at the University of Oxford, with demand reduction ranging from 5% to 15%.

The benefits to firms seem clearer. Automatic meter reading removes the need for platoons of meter readers and cuts down on paperwork. In theory, the meters will pay for themselves. Firms could offer different prices at different times of day, smoothing out predictable consumption peaks such as those in the early morning and early evening. That would make life easier for power-station operators and cut carbon emissions (since such demand peaks tend to be met by quick-starting but relatively dirty power stations).

Greener and wiser
Household energy consumption, 1970=100

1998 99 2000 01 02 03 04 05 06 07 (scale 50–100)

Source: BERR

Bigger changes are possible in the long run. Appliances designed to work with smart meters could be switched off remotely by power companies at periods of high demand (fridges are a common example, since they do not need to run all the time). The ability to control demand would make it easier to fit large amounts of intermittent renewable energy into the electricity system without running expensive backup generation. Households that generate their own power (with combined heat-and-power plants or solar panels, say) could sell spare juice back to the grid.

There are a few gripes. Some worry that energy firms will pocket the savings rather than share them with customers. Others note that the consultation dwells more on benefits for firms than for consumers (in theory, a smart-metered household could automatically switch supplier every time it was advantageous to do so, for example).

Nevertheless, the plans are ambitious, a quality not lacking in British climate policy. But targets are harder

to hit than to set: existing pledges on carbon emissions and renewable-power generation have been missed; imminent ones look impossible to meet. Yet the opposition Conservatives, who will probably form the next government, are even more gung-ho than Labour. Greg Clark, Mr Miliband's shadow, described the plans to roll out the smart meters as "frustratingly slow".

Bagehot

The atonement moment

May 14th 2009
From The Economist print edition

There is a mood of penance in Britain. Gordon Brown can make use of it

Illustration by Steve O'Brien



ON YOM KIPPUR, the Day of Atonement and holiest festival in Judaism, worshippers beseech God's pardon. Striking their breasts, they repent of the sin of slander, the sin of arrogance, the sins of stubbornness and of bearing false witness. They atone for any wrongs that would have incurred the four fearsome death penalties imposed in the age of the old Temple: stoning, burning, beheading and strangulation. They plead to be inscribed in the book of life, as the gates of heaven close.

Britain is living through a sort of Yom Kippur moment. Atonement and repentance are in the air. It isn't only MPs and their expenses scams (see article and article). Some were already seeking absolution for screwing up the economy. Then there are the faux-contrite bankers, the remorseful policeman who exposed top-secret counter-terrorist plans and still more improbable penitents.

The *London Evening Standard*, the capital's main newspaper, has launched an unusual, self-lacerating advertising campaign. A series of posters say "sorry" for a variety of cardinal editorial shortcomings: for "taking you for granted", "being complacent", "being predictable". Meanwhile Marks & Spencer, Britain's leading clothing retailer, has beaten its breast for overcharging women with large ones. Customers protested over the £2 ($3) premium added to the price of big bras; M&S at first rebuffed them, but then capitulated. "We boobed", their adverts concede, announcing that the surcharge would be scrapped (and, naturally, using the backtrack as a pretext for a pectoral close-up).

These are not the first firms to use self-deprecating marketing. "We're number two," Avis once proclaimed. "Love it or hate it" is the strap line for Marmite, a pungent breakfast spread. But the recent commercial apologies are especially risky. Some formerly satisfied customers or readers will be retroactively aggrieved. Staff at the *Standard* may not be altogether happy to see their past labours repudiated. But like the rush to mea a few culpas elsewhere, the strategy is a response to a subtle but palpable shift in the public mood. It is restive, confused, gently millenarian.

Partly, of course, this is the atmosphere of recession. Many consumers feel pinched, or expect to; they are looking for savings and reassessing their outgoings. Cut-price clothiers threaten M&S; London freesheets are winning readers from the *Standard*. But it isn't only the slump and the skint. The credit crunch, the approaching general election and now the cross-party shaming of Parliament (and, perhaps, the advent of Barack Obama) have also contributed. So has a quiet collective guilt over the financial excesses of "the

age of irresponsibility”. There is a vague sense of eras ending and beginning.

So, in a way, this is the worst of times for MPs to be caught in the sin of horse manure, the sins of mole-clearing and of pool-cleaning. Nurses and teachers will be livid about cuts imposed by people who ride lawnmowers their taxes paid for; the “coping classes” will be even crosser about taxes that are dodged by the ministers who devised them. Yet the mood also opens up an opportunity for politicians to recast their relationship with the public—especially, perhaps, the prime minister.

Gordon’s chance

Even if every Labour MP were as clean as a Tory swimming pool, the expenses scandal would still hurt their party. Labour is the long-term incumbent; political problems of all kinds are naturally blamed on the government. It is particularly damaging for Gordon Brown: whatever his other failings, nobody has hitherto accused him of being a pocket-lining spiv (like that other fella Blair). The Tories will suffer too, because of the reinforced perception of unearned privilege. Within the party there will be resentment of the wealthy top brass, including David Cameron, the Tory leader, from those who will more sorely miss their inflated allowances. But the backlash looks set to be worse for Labour.

Mr Cameron has striven to make it so. He is a serial political apologist, saying sorry, sacrificing an aide and obliging his shadow cabinet to pay back their most egregious claims, like medieval Christians buying indulgences. Mr Brown, by contrast, has blathered on about committees, seeming defensive and reactive rather than leaderly. Still, like the banking crisis which gave him a bounce last autumn, the expenses furore and the liminal feeling it has reinforced offer him a shot at redemption. To exploit it, he must be at least as bold as he was in the bank bail-out. Self-flagellating is not sufficient expiation: the price of the bra must be cut, the newspaper redesigned, or, in this case, politics overhauled.

For a start, Mr Brown could outdo Mr Cameron by dispensing the three fearsome political penalties to Labour’s worst expenses miscreants, including some in the cabinet: ministerial sacking, withdrawal of the whip and deselection by constituencies. After this knowledge, he could insist, no forgiveness. And he shouldn’t stop at parliamentary discipline. Henceforth, Mr Brown could say, I will be franker about the economy. I will answer interviewers’ questions. I will scrap the ID-cards scheme and other costly fixations. I will be less partisan. It isn’t only the expenses, he could declare: I understand the mood; politics must change.

“I am sure it is a bad thing,” Churchill said in 1954, “to have the tremendous affairs and responsibilities of the state discharged by men, a large number of whom are themselves seriously embarrassed.” He was talking about the embarrassment of penury—and advocating higher salaries for MPs. Parliament is now woefully embarrassed for the opposite reason. It will be hard for all politicians, including Mr Brown, to shrug this off. He cannot rebrand himself as readily as a company. But things could scarcely get much worse for the prime minister than they are now. The book of political life and death is closing; the electoral gates will soon slam shut. He needs to seize the atonement moment.

Economist.com/blogs/bagehot

Pope Benedict

A chapter of accidents

May 14th 2009
From The Economist print edition

The pope's visit to the Holy Land adds another public-relations disaster to the string that already exists. Why should this be?

AP



TO UNDERSTAND the personal baggage that Pope Benedict XVI brought to the Holy Land this week, it is worth looking at his most accessible book, "Jesus of Nazareth", published two years ago. With a mixture of intense piety and arcane scholarship, he reflects on the Jewish origins of Christianity's dogmas and rites in a way that shows deep interest in the religion of ancient Israel—yet total conviction that the older faith's true meaning is to be found only in Christ. Both in its rigour and in its devotion, the pope's writing reflects the enclosed places in which he has spent most of his 82 years. First, the formal atmosphere of German academia, where charisma is a dirty word; and then the upper echelons of the Vatican, a world whose ethos, reasoning and vocabulary are utterly remote from the lives of most lay Catholics, let alone everyone else.

No surprise, then, that he lacked the street sense to send the right signals on a trip to the front line: the Middle Eastern confrontation zone of the three monotheistic faiths, Christianity, Islam and Judaism, a region that tests the skills of the savviest statesman. In the event, he deeply upset his Israeli hosts, and to a much milder extent his Palestinian ones too, both mainly through sins of omission.

On his arrival in Israel, Benedict spoke some of the words that Israelis were waiting to hear. He honoured the memory of the 6m Jewish victims of the Holocaust, noting that: "Sadly, anti-Semitism continues to rear its ugly head in many parts of the world. This is totally unacceptable." The trouble came when he made his more publicised speech at the Yad Vashem Holocaust shrine a few hours later. In this he spoke only of "millions" of Jewish victims, not of "six million", an omission that had the effect of reopening the barely closed controversy over the pope's readmission into the church, four months ago, of a British bishop, Richard Williamson, who denies the extent of the Holocaust.

The pope then made things worse for himself by speaking of the "tragedy of the *Shoah* [Hebrew for the Holocaust]" without attributing blame. This led to Israelis raking over his own early life as a soldier in the *Wehrmacht* and before that as an (unwilling) member of the Hitler-Jugend. And yet another mistake: the pope used the word "killed" rather than "murdered".

This close parsing of what was essentially a compassionate speech, full of well-chosen Old Testament associations and passages from Lamentations, will seem casuistic to most. But the near-unanimous verdict in Israel was bitter disappointment. The pope had managed to rile, not to reconcile. Right-wing and religious politicians who had stayed away from the ceremonies crowed. Even steadfast interfaith activists criticised the lack of sensitivity evinced in the speech.

A tactful statement the next day at the Western Wall might have improved matters. But the pope made do with a barely audible prayer in Latin and a petition on paper, which he slipped between the stones, asking: “God of Abraham, Isaac and Jacob, hear the cry of the afflicted, the fearful, the bereft; send your peace upon this Holy Land, upon the Middle East, upon the entire human family.” This, though unexceptionable, was seen as yet again avoiding the painful essence of Holocaust expiation and was compared unfavourably with Pope John Paul II’s prayer in March 2000 at the same spot.

Islamic clerics escorted the pope to the Dome of the Rock in Jerusalem (shown above), to Bethlehem and to Nazareth. But others expressed disappointment that he did not apologise for a lecture given in 2006 which included a damning quotation about Muslims. They also complained that Gaza was excluded from the itinerary. Sheikh Taysir Tamimi, the chief Islamic justice, interrupted an interfaith discourse with a passionately political speech.

On the whole, however, the pope’s words to the Palestinians avoided pitfalls. Addressing the Muslim majority as well as the dwindling Christian minority (since the creation of Israel, the number of Christians in the Palestinian territories has fallen from 15-20% of the Palestinian population to less than 1.5%), he said: “I know how much you have suffered and continue to suffer as a result of the turmoil that has afflicted this land for decades.” He added that the Vatican “supports the right of your people to a sovereign Palestinian homeland in the land of your forefathers, secure and at peace with its neighbours, within internationally recognised borders.” He then appealed to the young not to allow “the loss of life and the destruction that you have witnessed to arouse bitterness or resentment in your hearts. Have the courage to resist any temptation you may feel to resort to acts of violence or terrorism.”

Finely weighted words that reflect the best of Vatican diplomacy, honed over centuries. Why then does Pope Benedict, supposedly served by specialists, slip up so often and so badly?

Where the faithful roam

Countries with the largest Roman Catholic populations, 2005

Country	Catholic population, m	As % of total population
Brazil	140.1	75.0
Mexico	93.2	89.4
United States	67.9	22.7
Philippines	66.6	78.8
Italy	55.8	95.2
France	44.6	73.2
Colombia	41.3	91.8
Spain	40.2	92.6
Poland	35.0	91.6
Argentina	34.8	89.7
Congo	27.8	47.4

Source: World Christian Database

Les trois gaffes

If the beliefs and disciplines of the Catholic faith were merely a private concern to the world’s 1.2 billion baptised Catholics, the pontiff’s remoteness from life’s realities might not be of great consequence. But no global faith is an island. The Vatican is a powerful actor in world affairs, one that can affect the likelihood of a “clash of civilisations”. So it matters that the frequency with which this accident-prone pope causes offence is accelerating.

In France, aggressively secular but steeped in Catholicism, churchgoers refer with a shudder to 2009 as the year of *les trois gaffes*. The pope’s three blunders were the rehabilitation of the Holocaust-denying bishop; a statement, en route to Africa, that condoms were no help against AIDS; and the church’s heartless reaction to the nine-year-old Brazilian girl who had an abortion after being raped by her stepfather. The Archbishop of Recife declared that everybody involved in procuring the abortion (the girl’s mother, the doctors) was excommunicated.

In all three cases, the story was not quite as simple as the headlines suggested. When the excommunication of Bishop Williamson was lifted, the Vatican did not know he had recently said there were no gas chambers, and that no more than 300,000 Jews had died; as soon as it learnt of his views, they were condemned unequivocally. Defenders of the pope have argued that his words on AIDS were quoted out of context, and that he was alluding to some respectable academic research that in Africa anti-AIDS policies based solely on condom distribution have been counter-productive. And horror over the church’s attitude towards the raped child was slightly appeased when Archbishop Rino Fisichella, head of the Pontifical Academy for Life, admitted that talk of excommunication had been “insensitive, incomprehensible and lacking mercy”.

Even so, all this is a far cry from the hopes expressed by many when Benedict was enthroned in 2005. It was felt that after the charismatic, globe-trotting John Paul, it was time for a pope who would concentrate on sprucing up the church itself, particularly in its European heartland. The scholarly German appeared to be the ideal choice to shore up an ancient ideal of a Christian, humanist Europe against the challenges posed by secularism.

Relations with the Muslims were not among his priorities. Indeed, the new pontiff was known to be

sceptical of the value of that inter-religious dialogue dear to the heart of his predecessor. It was thus ironic that Benedict should have first run into trouble with the *faux pas* that his Islamic hosts were still worrying about this week. In a lecture at the University of Regensburg in 2006, he quoted (though without endorsing) a Byzantine ruler who said that Muhammad brought “things only evil and inhuman, such as his command to spread by the sword the faith he preached.”

That lecture, which triggered riots and cost lives in several parts of the world, won him quiet admirers in some new quarters, ranging from the American neoconservative right to a sprinkling of European intellectuals. “The reaction to Regensburg, in which people died, proved his point: that Islam is a violent religion,” declared a Vatican official close to the pope’s thinking.

Others within the Vatican argue that the lecture was a “necessary provocation” that succeeded in eliciting a more considered Muslim response, including a proposal from Islamic scholars and clerics for a theological dialogue known as the “common word”. Yet many supporters of that dialogue, including members of the Jordanian royal family, were passionate for Christian-Muslim amity long before any “provocation” from the Vatican.

Saying the unsayable

To his defenders, Benedict is a rare, politically incorrect voice in a world cowed by intellectual conformity. “It is not so much that what he says is controversial, but that people find it painful to hear,” said a conservative Catholic layman in Rome. Others see his most controversial pronouncements, and in particular the outcry over his attitude to condoms, in a quite different light: as evidence of the vast gap that has developed between the leadership of the Catholic church and modern society.

Neither view excuses the giving of avoidable offence. In 2007 Benedict cleared the way for wider use of the old, Tridentine Latin mass. The rite he encouraged includes a prayer on Good Friday that calls for the conversion of the Jews. This is entirely consistent with the views of the man who signed off on the Vatican’s 2000 declaration, “Dominus Iesus”, which states that “to consider the Church as [merely] one way of salvation alongside those constituted by the other religions” is “contrary to the faith”. But nobody in the Vatican appeared to notice, or care, that the reinstated prayer contained a reference to the “blindness” of the Jews. It was removed the following year. But why had it not been deleted in advance?

The revival of the Tridentine mass was emblematic of another increasingly evident aspect of Benedict’s papacy: his progressive reversal of the changes that followed the Second Vatican Council of 1962-65. This policy, say his critics, is polarising his church, though more so in the rich West than in the developing world where Catholicism continues to grow (but not necessarily in the way that the pope wants; see article).

AP



An African sceptic

Another frequently voiced complaint is that he has failed to get a grip on the Roman Curia, the central administration of the church. The symptoms of this were particularly evident at the height of the Williamson affair, which a German cardinal, Walter Kasper, blamed on “misunderstandings and management errors” in the papal bureaucracy. Officials, he said, had “spoken too little to each other, and have not checked where problems might arise.”

In an apparent effort to introduce new ideas into the Vatican, Benedict has appointed several non-European and/or pastoral bishops to senior posts. The most important job a pope has to fill is that of the secretary of state, who is roughly equivalent to a prime minister. Benedict’s choice was unquestionably ground-breaking. Cardinal Tarcisio Bertone is almost alone among his predecessors, going back 300 years, in never having been schooled at the Accademia Ecclesiastica, the Vatican’s college for diplomats.

Indeed, diplomacy is not the bluff, 74-year-old cardinal’s strong point. A member of the Salesian order, whose particular mission is to work with the young, he is quintessentially a pastoral cleric rather than a church bureaucrat. That might have recommended him for the task of overhauling an administrative machine that John Paul barely touched. But, say insiders, Cardinal Bertone has failed to create a base from which to launch reforms and strikes an increasingly beleaguered figure, unable to impose his will on the Curia.

The papal bureaucracy has two obvious weaknesses. The first is that it is a gerontocracy. Its departmental bosses have crushing workloads. Yet many are well past normal retirement age. The other shortcoming is a lack of consultation in an administration which has nothing equivalent to a cabinet. Decisions are referred upwards to the secretary of state, and from him to the pope. Under John Paul the Curia acquired a string of new "pontifical councils", quasi-ministries that deal with everything from health workers to canon law. Many observers had expected that Benedict would reduce their number. He has not and, with similar inertia, has kept in office seven cardinals who, having passed their 75th birthdays, are due for retirement.

Liberals and conservatives alike agree that John Paul's talents distracted attention from the fact that the Curia had failed to adapt to a fast-changing world. Nowhere is that more obvious than in the corners of it that interact with the media. The late pope, who once dreamed of becoming an actor, needed much less support in this area than his retiring successor. Yet Benedict has reduced still further the scant resources assigned to external communications. His spokesman, Father Federico Lombardi, also has responsibility for the Vatican's radio and television services—and, unlike his predecessor in the office, does not have direct access to the pope.

That alone exposes Benedict to the sort of controversies that are in danger of becoming the hallmark of his papacy. But the risk is increased by the fact that, unlike John Paul, he writes most of his own speeches and, say insiders, often does not show them to anyone before delivery.

A hermit manqué

His Regensburg address was circulated in the Vatican and to some of its associated institutions, where it duly raised eyebrows among officials and scholars. But it appears that none of them had a channel through which to express their misgivings to the pope. As for Father Lombardi, he is understood to have tried in Germany to make a last-minute attempt to warn Benedict of the possible consequences. According to a well-informed source in Rome, he was told His Holiness was sleeping, and could not be woken.

The pope is not oblivious to the damage the Holy See's image has suffered, and is said by officials to be planning changes in the Vatican's media operations. He is clearly dismayed by the rifts that have opened up with other religions, and has gone some way to repairing them. But what is less clear is whether this most unworldly of pontiffs hopes, or wants, to placate those who object to his intense traditionalism, or whether he is willing, or able, to rally his bureaucracy.

Before setting off for the Holy Land, he offered what may have been a glimpse of the view that he has of himself and the burden he has been asked to take up. His previous high-profile engagement was a visit to the earthquake-stricken Abruzzo region of central Italy. As expected, he visited the shattered basilica where one of his predecessors, Celestine V, is buried. But, as was not expected, he took with him one of his most treasured possessions—his pallium, the woollen band he received when he was invested as pope—and left it behind on Celestine's tomb.

Like Benedict, Celestine was an intensely spiritual figure, a hermit, dragged from his refuge in the mountains in 1294 to be given charge of a troubled Catholic church in the hope that he could regenerate it. Like Benedict, he was criticised for lacking administrative talent. And after five months, he resigned. There must now be moments when Pope Benedict looks back with understanding at the plight and flight of his saintly predecessor.



The view from Brazil

An unruly bunch

May 14th 2009 | SÃO PAULO
From The Economist print edition

How the church is faring in the world's biggest Catholic country

THOUGH Pope Benedict's tenure has not had much effect on Catholicism in Brazil so far, it has entrenched an old conflict. The previous pope's reign saw a "decapitation of the progressive parts of the church in Latin America and particularly in Brazil," says Antonio Pierucci of São Paulo University. This war against the progressives was promoted by Benedict when he was still Cardinal Joseph Ratzinger. Its price has been a loss of political influence for the church hierarchy, whereas the liberation theologians whom the bosses shunned continue to have the ear of President Luiz Inácio Lula da Silva's Workers' Party. Pope John Paul's charisma partly compensated for this loss of influence. Pope Benedict does not have that to fall back on.

Even so, there is little evidence that problems at the top are affecting Catholic worship in Brazil. The census provides data on religious belief stretching back to 1872. The share of Brazilians who described themselves as Catholic fell from 99.7% in the first census to 73.9% in 2000. Almost two-thirds of this reduction happened in the 1980s and 1990s, when Catholics were apparently drawn away to new Pentecostal churches.

Yet since 2000 something strange has happened, says Marcelo Neri of Fundação Getulio Vargas, a think-tank and business school. Numbers taken from surveys of consumers (which include a question about religion) show the gradual decline levelling off in the early part of the decade. This turnaround seems to have come at the expense of those who describe themselves as being without religion. There is nothing to suggest that this trend has been interrupted.

The Catholicism being practised might, however, be considered by the Vatican to be of the wrong kind. One challenge to orthodoxy comes from charismatic priests who use pop-star tactics, and are taking on the upstart Pentecostals at their own game.

A second challenge comes from the popular Catholicism that tends to flourish best in those parts of rural Brazil where the church has little presence. In much of the north-east, Padre Cícero, a 19th-century priest who performed the odd miracle and seems to have been excommunicated as a result, has long been sanctified. In many places, children who die or people who suffer unpleasant deaths can be granted a kind of sainthood and asked to intervene on behalf of the living. The pope faces a struggle to steer this bunch in the direction of the orthodoxy he reveres.

Rebuilding the banks

May 14th 2009
From The Economist print edition

A tamer banking industry is already emerging from the debris of the old, failed one, says Andrew Palmer (interviewed here)

Illustration by R. Biesinger



BANKING is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently; instead, they ladled credit to anyone who wanted it. Banks are supposed to make money by skilfully managing the risk of transforming short-term debt into long-term loans; instead, they were undone by it. They are supposed to expedite the flow of credit through economies; instead, they ended up blocking it.

The costs of this failure are massive. Frantic efforts by governments to save their financial systems and buoy their economies will do long-term damage to public finances. The IMF reckons that average government debt for the richer G20 countries will exceed 100% of GDP in 2014, up from 70% in 2000 and just 40% in 1980.

Despite public rage over bank bail-outs, the industry has also comprehensively failed its owners. The scale of wealth destruction for shareholders has been breathtaking. The total market capitalisation of the industry fell by more than half in 2008, erasing all the gains it had made since 2003 (see chart 1).

Worth less 1
Global banking industry, total market capitalisation
$trn
% change on previous quarter
-13.2 -10.0 -12.7 -29.9
8 6 4 2 0
2007* Q1 2008 Q2 2008 Q3 2008 Q4 2008 2008*
Source: Boston Consulting Group *Year end

Employees have scarcely done better. The popular perception of bankers as Porsche-driving sociopaths obscures the fact that many of the industry's staff are modestly paid and sit in branches, information-technology departments and call-centres. Job losses in the industry have been savage. “Being done” used to refer to hearing about your annual bonus. Now it means getting fired. America's financial-services firms have shed almost half a million jobs since the peak in December 2006, more than half of them in the past seven months. Many have gone for good.

The pain is nowhere near over. The credit crunch has been a series of multiple crises, starting with subprime mortgages in America and progressively sweeping through asset classes and geographies. There are now some glimmers of optimism in the investment-banking world, where trading books have already been marked

down ferociously and credit exposures to the real economy are more limited. But most banks are hunkering down for more misery, as defaults among consumers and companies spiral. In its latest *Global Financial Stability Report*, the IMF estimates that the total bill for financial institutions will come to $4.1 trillion.

With so much red ink still to be spilled, it may seem premature to ask, as this special report does, what the future of banking looks like. For most industries, failure on this scale would mean destruction, after all. Banks, notoriously, are different. The most seismic event of the crisis to date, the bankruptcy of Lehman Brothers last September, demonstrated the costs of letting a big financial institution collapse. Trust evaporated and credit dried up. “October was the most uncomfortable moment in my career,” recalls Gordon Nixon, the boss of Royal Bank of Canada (RBC). “There was a possibility that the entire global banking system could go under.”

Concerted actions by governments since then, first in the form of capital injections and liability guarantees, and more recently via schemes to buy or guarantee loans, have signalled their determination to stabilise and clean up their big banks.

Politics notwithstanding, the commitment of governments to defend their banking systems removes the existential threat to the biggest institutions (or, more precisely, transfers it to sovereign borrowers). Bank bosses have learnt not to pronounce too confidently about the future. If the IMF’s loss predictions turn out to be accurate, there is still too little capital in the system. But most think that the chance of another Lehman-style blow-up has been greatly reduced.

There is still great uncertainty about the nature and extent of the support that governments will end up offering to their banks. But governments are now deeply embedded in banking systems. They are guaranteeing far more retail deposits than before the crisis. They are guaranteeing the issuance of new debt. They own preferred shares in many banks, common equity in others and stand ready to inject capital in others still. Banks that have not taken a scrap of government money still benefit from their stabilising presence. “We all exist at the largesse of the government right now,” says a bank boss.

The types of losses that banks now face have also changed. The huge writedowns on trading-book assets that defined the first phase of the crisis were horribly unpredictable. The complexity of structured finance made it difficult to know how losses would cascade down the ladder of investors in securitised assets. The patchy credit histories of subprime and low-documentation borrowers made it hard to model default rates accurately. And mark-to-market accounting meant that banks were valuing illiquid assets at prices which reflected a lack of buyers as much as underlying credit quality (accounting-standards bodies have since been bullied into allowing bankers to exercise more judgment in how they classify and value such assets).

Although the losses that banks face in their loan books are ugly, they should be more predictable. Shocks are still likely: for instance, the size of the bubble and scale of the bust may overturn historic relationships such as that between unemployment rates and credit-card losses. But losses on loans can be recognised in the accounts more slowly. And the assets that are now under scrutiny may be much bigger than their subprime predecessors but they are also better understood. “The scale of the recession is unprecedented but it is more familiar terrain,” says John Varley, the chief executive of Barclays.

The forgotten art

With government backing assured and impending losses somewhat more predictable, the big banks are slowly starting to lift their heads from the floor. Meetings with investors have been dominated for the past 18 months by discussions about banks’ balance-sheets and, in particular, the amount of capital that banks had. “This is my first experience of the quarterly-earnings game where no one has cared about earnings,” says Bob Kelly, the boss of Bank of New York Mellon.

That is changing. Even the biggest victims of the crisis expect to return to profitability this year. Galling as it may be to contemplate the returns that will once again accrue to banks, the rest of us badly need them to make money. Just as the prospect of continuing losses is what has stopped private capital from entering the system, the prospect of future profits is what will lure investors back in to replace governments. Profitability is also critical to the ability of banks to cover future losses without calling on further government cash. The situation is fluid but analysts at Barclays Capital reckoned in March that cumulative pre-tax and pre-provision income at the top 20 American banks for this year, 2010 and 2011 will be $575 billion, just enough to cover their estimates of losses in that period of $415 billion-$560

billion.

Profits need to be sustainable, of course. They may be the first line of defence against trouble but they disappeared all too quickly during this crisis, wiped out by writedowns and by the implosion of business models. “The discounted future profit streams of financial institutions went from quite something to almost nothing in an instant,” says Andy Haldane, head of financial stability at the Bank of England.

Banks recognise this as much as regulators do. There is a striking degree of convergence between the thrust of planned regulatory reforms and the new strategic thinking of many institutions. Greater resilience is a shared objective. Banks are reducing their dependence on wholesale funding and increasing their reliance on “stickier” deposits. They are reducing the amount of risk they take, which means reducing their proprietary trading and concentrating more on clients and activities that consume less capital. They are rapidly shrinking their balance-sheets. “The banking industry got it so wrong and destroyed so much value that it is difficult to sit in front of investors and say we are going to carry on as before,” says Richard Ramsden, an analyst at Goldman Sachs.

The future looks different to different types of banks. For smaller ones that fall outside the comforting embrace of the state or have less diversified loan portfolios, the outlook is bleaker. American regional banks and Spanish savings banks, or *cajas*, are among those coming under increasing pressure as commercial-property portfolios suffer. Mike Poulos of Oliver Wyman, a consultancy, expects the number of banks in America, currently some 8,000 or so, to drop by 2,000 or more as a result of the crisis.

Banks in many emerging markets will suffer as the economic climate deteriorates but they need to deleverage less. There is also less need for regulatory change. The Asian banks kept their exposure to cross-border funding flows under control, for example, unlike their peers in eastern Europe. The scale of structural change that these institutions face is relatively limited.

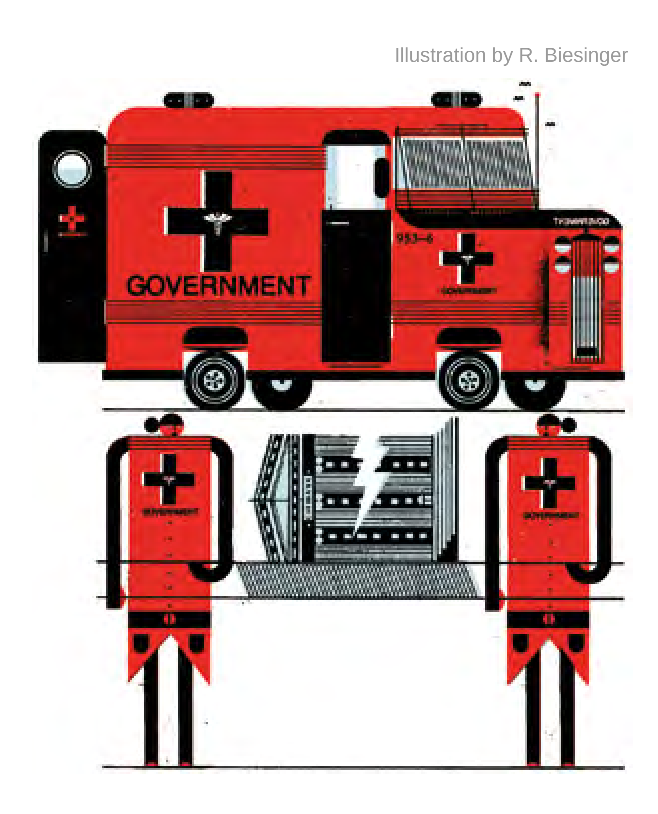
But for those banks at the heart of the crisis, the household names of Western finance, the landscape is different. Their future is secure enough for them to be able to plan beyond survival. Their failures have been big enough for them to know that everything they do, from the way they manage their balance-sheets to the way they pay their managers, has to change. But in seeking to work out what the new normality will be for banks, the first question to ask is how quickly and on what terms governments will disentangle themselves from the industry.

Exit right

May 14th 2009
From The Economist print edition

The contract between society and banks will get stricter

Illustration by R. Biesinger



NOTHING highlights the scale of banking's upheaval better than the intervention of governments. An industry that embodied the free market turns out to be pathetically dependent on the state for its survival. In some cases, the civil servants are officially in charge. The taxpayer is already the majority owner of Royal Bank of Scotland (RBS) and Lloyds Banking Group in Britain. The German government is poised to take control of Hypo Real Estate. American taxpayers are set to own the largest single stake in Citigroup. In many more cases, officials exercise control without formal representation, imposing pay limits and lending targets. The government is the industry's largest shareholder and the guarantor of its liabilities.

Yet the magnitude of this shift can easily be overstated. Governments routinely step in to rescue banks at times of systemic distress, observes Claudio Borio of the Bank for International Settlements. Rating agencies have long assessed banks' creditworthiness in part on the likelihood of government support should they get into trouble. Their judgment, as everyone knows, is not always right. Moody's was pilloried in early 2007 for awarding gold-plated AAA ratings to the big Icelandic banks on the false premise that the authorities in Reykjavik could afford to rescue them. But the assumption that governments will try to help a big bank in crisis is nothing new.

This contract to intervene was first legally recognised after the Depression, when the Glass-Steagall act of 1933 created the Federal Deposit Insurance Corporation (FDIC). Since then, similar deposit-guarantee schemes have been created around the world to help persuade savers, who are otherwise unsecured creditors of their bank, not to remove their money if it gets into trouble. Indeed, some advocates of free markets argue that this guarantee of compensation helped to cause the current crisis, by reducing the incentives for depositors to look closely at their banks.

Whatever the merits of that argument, it is whistling in the wind to suggest that the state should withdraw from its commitment to support banks in times of trouble. "The body cannot survive without blood," says Bo Lundgren, one of the architects of Sweden's vaunted bank-rescue package of the early 1990s, "and the economy cannot survive without banks." But now that this commitment has been called on so dramatically, three questions arise. The first is how long the state will remain so explicitly involved

in the industry. The second is what immediate distortions that involvement creates. And the third is what additional charges governments will levy on the industry in future for providing banks with such a huge safety net today.

The answer to the first question will be measured in years. Take Sweden's bank bail-out. It was more successful than anyone had expected but it still took four years for the liability guarantees to be lifted. Nordbanken, the seed of today's Nordea, was fully nationalised in 1992 and partly refloated three years later but the Swedish state remains its largest shareholder.

The Swedish policymakers' task was also less daunting. The bad assets in their banks were more homogenous and easier to value than those currently clogging things up. The Swedes intervened at the end of a recession, so banks quickly benefited from the recovery. Governments today have had to step in earlier in the economic cycle, implying a longer period of engagement for two reasons.

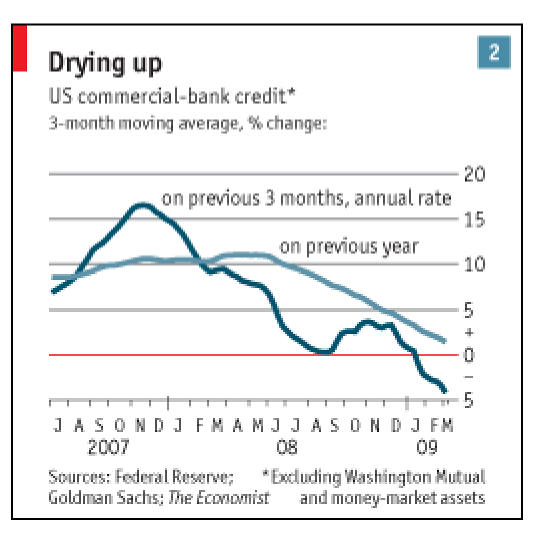
First, while loan losses continue to raise doubts about banks' solvency, the presence of governments will be necessary to reassure creditors and counterparties. In America the healthiest banks are increasingly vocal about their desire to repay money from the Troubled Asset Relief Programme (TARP). But many bankers also recognise that they should not be too hasty in their bid for freedom. We are not going to pay off TARP money until we are certain we don't need it, says a bank boss.

Regulators may not allow relatively strong banks to buy out the government early in any case, for fear of a further lurch downward in the economy and of leaving straggling institutions vulnerable to attack from short-sellers. "The idea of TARP repayment is a nonsense," steams a Wall Street executive. "It all has to be paid back at the same time."

Finding a way out

Even if it is feasible to replace government equity fairly quickly, most believe that it will take far longer for governments to exit their debt guarantees. Banks have lots of bubble-era debt to refinance this year and next. The coming torrent of government borrowing may make it harder for banks to attract private funding. And the more government-backed bank debt is issued, the greater the risk of creating another refinancing problem when state guarantees expire.

The second reason why governments need to stay engaged is to counter the banks' usual instincts during slowdowns. The obvious thing for banks to do in a recession, let alone one in which trust in counterparties has been shattered and a credit bubble is deflating, is lend less (see chart 2). Governments are urging banks to lend more to prop up the economy, even though in the long term they will want them to be more cautious lenders.



The political imperative for governments to try to make a return on their investments complicates matters further. Banks will have to look relatively risk-proof before they can be passed back into private ownership at a profit. All of which suggests that governments have to negotiate a prolonged transition before they will exit all of their investments in banks or remove their liability guarantees.

The longer governments stay involved, the more they will distort competition. Normally, private firms moan about having to compete with state-backed rivals but in this case government backing is likely to change from a boon into a handicap. Bank bosses in America who welcomed the initial injection of TARP capital have become progressively less enthusiastic about it. Those who have stayed outside the government net, in terms of equity participation at least, are revelling in their independence. "There is some tactical advantage to government money but it is deeply politicised," says the boss of a big bank which has not taken state cash.

Compensation is the obvious example. The top 25 employees at banks that have taken TARP money face tight regulation of their incentive-based pay until the government has been paid back. Prior bonuses are also at risk from punitive tax proposals. That may be sustainable for a while, says another boss: "We can say for a year or two that 'we value you, you're a leader and if you stay with us we will make it up to you'." But eventually competition from unfettered rivals will tell.

Freedom to act on the international stage is particularly prized by institutions that have not taken government cash. Taxpayers have little interest in seeing their money used to finance activities in other countries: they want it used for lending at home. The dismantling of RBS's global empire is the most conspicuous example of this type of financial nationalism, but pressure to lend domestically is universal. With many competitors gone, impaired or under the cosh of government masters, banks that have been able to keep operating normally in global markets are already grabbing new wholesale business. Capital-raising is easier for independent banks too because shareholders and politicians have different priorities. "Investing capital where government is involved on a continuing basis is difficult because of concerns over restrictions on marketing and compensation expenses," says Gary Parr of Lazard, an investment bank.

There are also disadvantages to having government-owned rivals. The obvious one is unfair competition. Northern Rock, a British bank which was nationalised in early 2008 and was originally told to shut its doors to new borrowers and shrink its book, abruptly changed course in February. It now aims to lend an extra £5 billion ($7.6 billion) in mortgages in 2009, and up to an additional £9 billion in 2010. If government-owned banks were to underprice risk for a long period of time in order to meet lending targets, everyone would feel under pressure to respond.

The shadow of the state

Let's be foolhardy and assume the best. Economies start to recover relatively rapidly. Governments are able to plot a relatively fast exit from their equity investments. And a revival in funding markets allows for a smooth exit from debt guarantees (as happened in Sweden). Even so, the crisis will leave a lasting mark on the terms of trade between banks and the taxpayers who periodically come to their rescue. "Banks have to have a licence to operate, which is granted by a common understanding of what is right and fair," says Hans Dalborg, the chairman of Nordea.

Some elements of this new contract between banks and society are already clear. Amendments to bank-capital regimes are certain, although regulators clearly do not want to squeeze banks to raise more capital until credit shortages have eased. There is now impressive momentum behind the idea of a leverage ratio, a measure that puts a fixed ceiling on the total amount of assets that a bank can hold relative to its capital. Some countries, including America, already have such a system, and others are fast coming around. The Swiss are introducing just such a ratio for their two biggest banks, which will be phased in by 2013, to sit alongside the international "Basel 2" capital rules.

Basel 2 takes a different approach to capital, charging banks on the basis of how risky their assets are. These "risk weights" will also become far more punitive. Ask supervisors about the biggest flaws in the previous regulatory framework and many will point to the meagre capital charges that banks faced in their trading books, which were based on disastrously optimistic assumptions about the liquidity, risk profile and price stability of assets such as mortgage-backed securities. These charges are going to be driven higher.

The liquidity of banks' balance-sheets will also be regulated more intensively. Britain's Financial Services Authority (FSA) has already issued proposed guidelines on liquidity which will require banks to hold a greater cushion of liquid assets, mainly in the form of government bonds. The proposals have attracted plenty of criticism but they are indicative of what is coming: a more robust approach to liquidity in general and, in the wake of the Lehman bankruptcy and the collapse of the Icelandic banks, greater efforts by national regulators to safeguard the local operations of foreign banks from the risk of their parents getting into trouble.

If the regulation of balance-sheets is set to become more prescriptive, other things will be designed to increase levels of uncertainty. Take the stance of Britain's newly scary FSA. Its previous philosophy meant that the regulator focused primarily on the management controls and systems that banks had in place. That passive approach will be replaced by a more intrusive and capricious regime, which questions the decisions of individual institutions.

Uncertain times

Widespread enthusiasm for a more "macroprudential" approach to regulation—in which regulators think harder about the stability of the system in addition to the health of individual institutions—also implies a higher level of uncertainty for executives. Banks that may be doing a good job could still find themselves

subject to higher charges if systemic risks are rising. Countercyclical rules requiring banks to beef up capital in good times and run it down in bad times may well rely on the discretion of authorities.

What of the two big structural questions that now dog industry regulators—whether to separate out "utility" retail banks from "casino" investment banks; and what to do about those banks that are too big to fail? Both problems have got more acute because of the crisis. Deals such as the takeovers of Bear Stearns by JPMorgan Chase, and of Merrill Lynch by Bank of America, have further blurred the boundaries between retail and investment banks, not sharpened them. Combinations like those of Wells Fargo and Wachovia, Lloyds TSB and HBOS, Commerzbank and Dresdner Bank have bloated the biggest institutions, not slimmed them. And the trend towards concentration of deposits among America's top banks has accelerated as a result of these deals, for example (see chart 3).



Yet despite some talk about the need for a new Glass-Steagall act to separate retail and investment banking, and for higher capital charges based on size, the idea of breaking up institutions does not have great momentum. No business model has come through the crisis unscathed and size is manifestly not the only attribute that makes a bank too important to fail.

Standalone investment banks have failed and, as Lehman vividly demonstrated, were too central to the architecture of global finance to disappear smoothly. Pure retail banks have imploded too. Investment bankers archly observe that judgments on which bit of the business is the casino ought to be withheld until the end of the credit cycle. The woes of Citigroup put paid to the myth of the indestructible universal bank, even as the success of Canada's banks (see article) showed that a system of a few domestic giants can work.

Any radical regulatory surgery would also require governments to mark out some very artificial boundaries. Take the distinction that some make between deposit-taking institutions, which should be protected, and wholesale-funded entities, which should not. With so much wholesale funding coming ultimately from individual investors in the form of pension and mutual funds, that distinction is blurrier than it first looks.

There are similar problems with defining the borders between acceptable and unacceptable activities. Peter Sands, the boss of Standard Chartered, an emerging-market leader, argues that there are swathes of the industry doing blameless but critical things like cash management and trade finance for companies that fall outside the definition of narrow banking.

What is more, any form of lending entails risk. The extension of credit to a small business is one of the riskiest things a bank can do, but it wins taxpayers' unequivocal support. Credit-default swaps are vilified, by contrast, but they serve a valuable function. "We will buy credit protection but not sell it, buy catastrophe risk [protection] but not sell it," says the boss of a bank that has negotiated the crisis successfully. Fine, but that implies it is useful for someone to be selling these kinds of instruments. Proprietary trading is harder to defend when it is sheltered by a government guarantee but any bank that acts as a marketmaker between buyers and sellers will end up taking some form of proprietary risk.

Faced with this untidy set of choices, a sensible philosophy would not make hard-and-fast judgments about what businesses belong together. Quality of management, not business models, is better at explaining the difference in performance between banks. The right approach conceptually is a dynamic regulatory regime that looks sceptically at the boardrooms and strategies of financial institutions and is capable of intervening effectively when need arises. In any case, systemic changes to institutions' balance-sheets will have a substantial impact on the types of businesses banks become.

Don't blame Canada

May 14th 2009
From The Economist print edition

A country that got things right

“IT IS the only time I feel like royalty,” says the boss of a big Canadian bank, describing the reception he now gets in America. He is not the only one basking in acclaim. All of Canada’s main banks were profitable in the quarter ending January 31st, when market conditions were at their worst. None has needed government investment. The country’s financial system has been praised by Barack Obama.

Trouble is, some differences between the two countries are culturally ingrained. “The United States has an inherently higher risk appetite,” says a banker familiar with both sides of the fence. It is hard to find pre-crisis equivalents in America of the decision by Toronto-Dominion (TD) to exit its structured products business in 2005, or the 20-30% band that RBC imposes on the share of earnings that its capital-markets business can contribute.

Structural differences matter too. The Canadian system is an oligopoly of five dominant banks. That dampens price competition: independent brokers originate less than one-third of the mortgages in Canada, compared with up to 70% in America during the bubble. It also makes it easier for Canadian banks to pull back when things are getting too risky.

Bank on Canada

Banks’ assets, 1997=100, C$ terms

Sources: Thomson Datastream; *The Economist*; Royal Bank of Canada; Royal Bank of Scotland

Having a few banks that are clearly too big to fail has led to more stringent supervision, including imposing a maximum leverage ratio and a single regulatory regime for commercial and investment bankers. Laxer and more fragmented capital regimes allowed the balance-sheets of banks elsewhere to balloon (see chart 4).

Perhaps the most striking divergence between Canada and America is in their regulation of mortgages. Interest paid on home loans is tax-deductible in America, encouraging people to borrow more; not so in Canada. American mortgages are non-recourse in many states, making it harder for lenders to pursue defaulting borrowers; not in most of Canada. (Then again, Britain is like Canada in these respects but still has soaring defaults).

Canadians taking out mortgages with a loan-to-value ratio over 80% must also take out insurance on them from a federal agency called the Canada Mortgage and Housing Corporation (CMHC). The banks insure the rest of their portfolios with the CMHC, which keeps them honest by applying strict standards to the mortgages they guarantee. Taking out insurance also brings the risk weighting that regulators apply to these mortgages down to zero, which means that the banks derive no capital advantage from funding them through securitisation. Some argue that Freddie Mac and Fannie Mae, America’s housing-finance giants, should likewise guarantee mortgages but not buy them.

Economist.com SPECIAL REPORTS

From asset to liability

May 14th 2009
From The Economist print edition

The shifting shape of bank balance-sheets

Illustration by R. Biesinger



THE dirty secret of the golden age of finance was that it was obscenely easy to make money. The supply of credit was seemingly inexhaustible, so banks could fund their expansion at will. Demand was equally insatiable, providing those infamously complex structured products with a stream of ready buyers. The years of plenty disastrously skewed risk models, allowing banks to run with lower capital on the assumption that past performance was, contrary to the industry's standard advice, a guide to future returns. And the theory that risk had been dispersed because of securitisation added to the false sense of security.

The result for many banks was a strategy of expanding their balance-sheets by writing more and more loans and holding ever more securities. With risk low, liquidity ubiquitous and many institutions under fire for appearing to be overcapitalised, there seemed to be little cost to growth. "If we could have an infinite balance-sheet for a penny return, we were going to take it," says a Wall Street veteran.

Things are somewhat different now. If boardroom discussion in the past decade revolved around the asset side of the balance-sheet, the next decade will see managers focusing on the liabilities side—the amount and quality of capital they hold to protect against losses, and the duration and sources of their funding. Banks will go from being unconstrained by their balance-sheets to being caged by them.

Start with capital, which has suddenly become the industry's scarce resource. That is particularly true today as the prospect of further losses continues to unnerve private investors. But it will remain true after the immediate crisis has eased. The amount of capital that banks have to hold will go up, and not just because their regulators want them to have a bigger buffer against losses.

The risk weightings on assets are rising as the effects of the downturn feed through into banks' risk models, forcing them to set aside more capital. Bondholders want a greater cushion beneath them in the capital structure to protect them against losses. Shareholders too are belatedly happy to trade higher returns on equity for a reduced chance of being wiped out. So banks with more equity capital are now valued more highly by the market. Between 2000 and 2007 there was no correlation between equity-capital ratios and the total return on banks' shares, says Mr Varley of Barclays. "Now the correlation is meaningful."

The amount of capital banks hold is not the only thing under scrutiny. They also need to have the right kind. Their capital is a mix of common equity, which is first in line when losses strike, and various other instruments, often hybrids of equity and debt. A gradual pre-crisis increase in the proportion of this sort of capital has accelerated rapidly in recent months, as common equity has been eaten up by losses and

governments have largely filled the gap with preferred shares, which helps to avoid nationalisation.

The curious effect of this changing capital mix has been to bolster banks' overall capital bases while disturbing shareholders, who see common equity as the only dependable bulwark against losses. Thus banks with less of it have been punished by the markets. "It turns out that hybrids don't have much loss-absorbing capacity and are not much use in a period of stress," concludes Mr Ramsden of Goldman Sachs. That realisation helps to explain why American commercial banks, despite appearing well capitalised compared with their European peers ahead of the crisis, have still had a capital problem. It also helps to explain the banks' rush to buy back hybrid debt at discounted prices: they can book the gains as profits and use these to beef up capital where it counts.

Holders of hybrid instruments, as well as of other forms of junior debt, have been given their own reasons to reflect. The British government's decision in February to amend the terms of subordinated debt issued by Bradford & Bingley, a nationalised bank, spooked European markets, for example. Bondholders were locked in when Deutsche Bank decided in December not to redeem a €1 billion ($1.3 billion) subordinated bond at its first opportunity. John Raymond of CreditSights, a research firm, says investors used to like buying debt lower down banks' capital structure because they thought its higher yield overcompensated for a marginal increase in risk. Now their thinking has changed.

Senior debtholders, who rank first in the hierarchy of unsecured creditors if a bank is liquidated, have less to worry about. In general regulators have stuck to the standard script of bank bail-outs, in which shareholders take the pain and bondholders are protected. And a bigger equity cushion should help to reduce the cost of debt by counteracting fears that debtholders are too exposed to losses.

Bank debt of all kinds will nevertheless be perceived as more risky after this crisis. Investors will not soon forget Washington Mutual's failure last September, when assets and deposits of the Seattle-based thrift were transferred to JPMorgan Chase but its creditors were left high and dry. Even in countries that do not formally prioritise depositors over other creditors, as America does, the political necessity of reimbursing taxpayers before anyone else has become crystal clear. Thanks to Iceland's crisis the creditworthiness of banks will also be far more closely tied to the creditworthiness of the countries in which they are headquartered.

The primary effect of all these changes will be to make it more expensive to expand the balance-sheet. Scared bank shareholders will now demand a higher risk premium, as will debtholders. Competition for capital and safer forms of debt will be greater, as investors demand fortress-like balance-sheets. And equity will go less far in a world where banks are more constrained in the amount of assets they can support with each unit of capital.

All this in turn will lead banks to think harder about where they deploy capital. Executives will ask tough questions about activities that absorb lots of capital but have lower returns now that leverage is lower, the risks are clearer and cost of funding is higher. "Some banks' balance-sheets could be expanded indefinitely in the past," says Paul Calello, the boss of Credit Suisse's investment bank. "Now that capital is more scarce the banks have to be even more efficient in their balance-sheet and capital usage to maximise profitability." Dedicated proprietary-trading desks, where a group of traders put the bank's own capital at risk, look much less attractive in this changed environment, for example. The advantages of running such desks have largely gone, says Bill Winters of JPMorgan Chase's investment bank.

Finer judgments about the liquidity of assets will also come into play. When markets are less liquid, assets stay on the balance-sheets for longer. That exposes institutions to greater risk and ties up capital that could be better deployed elsewhere. Credit Suisse is planning to continue to operate in American residential mortgage-backed securities (RMBS), for example, where markets are deeper and more liquid, but exit the sludgier European RMBS market, where the bank is forced to hold assets for longer.

Businesses that throw off plenty of earnings without absorbing much capital or running great risks are naturally in demand. Take the advisory businesses of investment banking, an area in which plenty of boutiques make a decent living without having a balance-sheet at all. Or custody businesses, where banks look after the assets of other financial institutions. Or asset management, where someone else's money is at risk. The two remaining independent investment banks, Goldman Sachs and Morgan Stanley, have both signalled greater emphasis on less capital-intensive businesses.

Debt dilemmas

Capital is not the only bit of the balance-sheet that will get a lot more attention in future. Executives (and regulators) will also focus more on the funding profile of their businesses in light of the crisis, as the costs of borrowing rise, lenders demand greater security and keener awareness of liquidity risk informs behaviour.

They will pay greater attention, for example, to whether assets can be used as collateral for further borrowing. Huw van Steenis, an analyst at Morgan Stanley, says banks will divide activities between those generating collateral that can be placed with central banks (high-quality mortgages, for example) or is otherwise decent enough to be used as security (shares, say), and those that do not throw off any collateral at all and therefore consume unsecured funding. The cost and scarcity of this type of funding means that these businesses—equity underwriting is an example—will command higher margins.

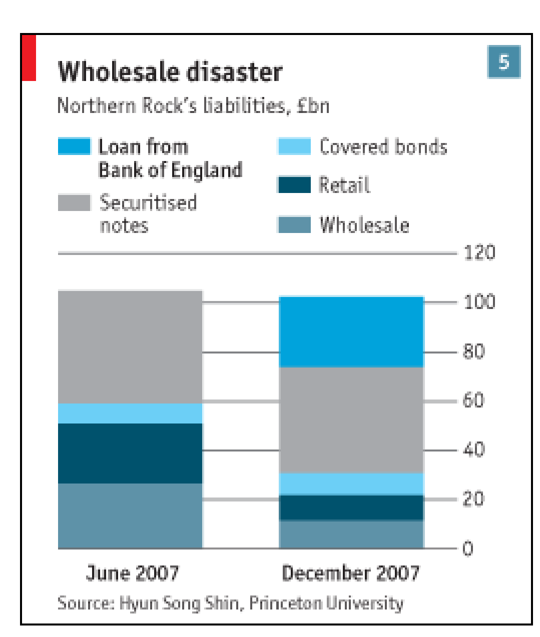
Above all, banks will have a deeper awareness of funding risk—their ability to roll over debts as they come due. Institutions that keenly exploited the pricing differences between long-term assets and short-term liabilities paid heavily when liquidity dried up and they were unable to refinance fast-maturing debts or sell the assets that they held.

To be more precise, the weakness revealed by this crisis has been in short-term wholesale funding, which rolls over quickly but does not have the government-backed guarantees that help to keep retail depositors quiescent. This type of funding has been at the heart of the crisis.

Many subprime mortgage-backed securities were held in off-balance-sheet vehicles that funded themselves by issuing short-dated, asset-backed commercial paper to money-market funds and other investors. When those funds suddenly stopped buying paper, the banks' liquidity lines to these vehicles abruptly came into force. Similarly, the amount of funding that investment banks were doing through overnight repo agreements surged between 2004 and 2007; they were rolling over one-quarter of their balance-sheets every day prior to the crisis, making them vulnerable to a sudden loss of confidence.

Short-term wholesale funding also helped to sink Northern Rock, one of the earliest victims of the crisis. The bank's failure in September 2007 is indelibly associated with images of Britain's first retail bank run since 1866 and is often blamed on its enthusiastic use of securitisation to expand its mortgage book. Yet a 2008 paper by Hyun Song Shin of Princeton University, dissecting the bank's implosion, suggests that neither the run nor securitisation was the principal culprit.

The retail run on the bank came in mid-September, when news broke that the Bank of England was providing it with emergency support. Yet Northern Rock had been experiencing funding problems since mid-August. The retail run came after the bank had already been destabilised by wholesale-funding problems. Nor can securitisation really be blamed for the withdrawal in funding. Northern Rock's securitisation vehicle issued relatively long-term notes to investors, so it did not face the threat of massive redemptions from this particular quarter. The first and most damaging run on the bank took place in its other short- and medium-term wholesale liabilities (see chart 5).



Faced with this stress fracture in their funding structures, banks have two obvious ways to respond. The first is to lengthen the maturity of the wholesale debts that they have. Some institutions have less far to go than others: the unsecured debt of Goldman Sachs already boasts an average maturity of eight years, for instance. But when markets get back to normal, funding maturities are likely to rise.

There are limits to issuance of longer-dated liabilities. A big rise in the proportion of long-term bond funding across the industry is bound to be costly, especially since banks will have to compete to attract interest from bond investors who already have exposure to many of these institutions anyway. Securitisation markets are badly damaged (see article).

The second option, and the more important shift, is for banks to increase their dependence on more stable deposits. The most dramatic volte-face has been that of the surviving investment banks, Goldman Sachs and Morgan Stanley, which became bank holding companies in September, making it easier for them to take deposits.

The upheaval in funding profiles is arguably greater for retail banks, however. Just as capital ratios are now strongly correlated with share prices, so too are loan-to-deposit ratios (LDRs). Among emerging European countries, where cross-border capital flows were critical and have now dried up, those with higher LDRs (ie, fewer deposits) have seen their banks' share prices dive the most (see chart 6).

Retail-bank bosses who had financed loan growth by tapping wholesale sources of funding are now targeting lower LDRs. Before it was snapped up by Lloyds TSB, HBOS, another stricken British lender, was trying to dispose of businesses that were dependent on wholesale funds and therefore increased the group's LDR. Many banks have now imposed limits on asset growth, requiring that loans do not expand more quickly than deposits.

A perennial industry debate, on the merits of bank branches versus other customer channels, has been given fresh piquancy by this need to gather in deposits—and the branch is likely to emerge strengthened. Studies consistently suggest that branch networks with a strong local presence are the most effective way to win deposits. Mr Shin's analysis of Northern Rock contains some fascinating detail on the retail-deposit run. Despite those snaking queues, customers with branch-based accounts were stickier than many others. Online account-holders fled in roughly similar proportions to branch customers. Holders of postal accounts and offshore accounts were flightier.

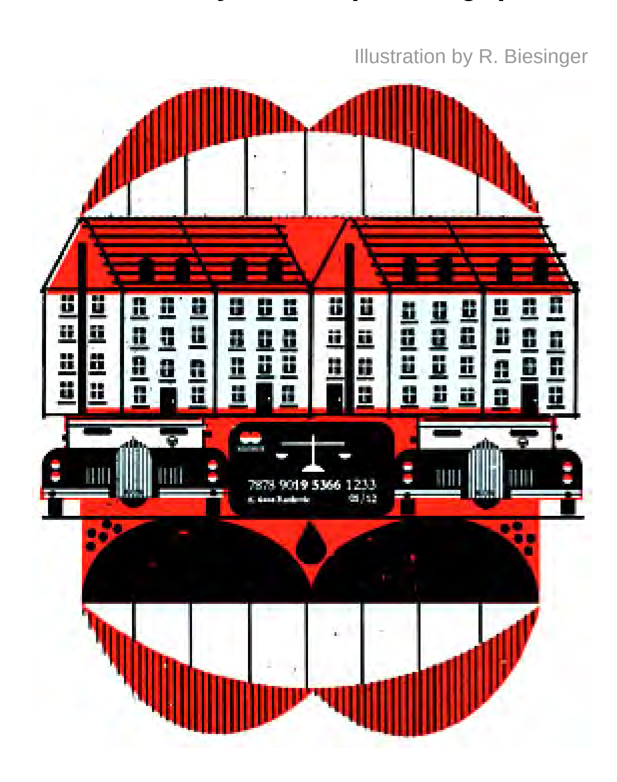
In truth, banks need to have a diverse set of funding sources and maturities, whether wholesale or retail. Relying on deposits alone still entails risk. Deposits can be withdrawn at a moment's notice, after all, and government guarantees do not stop depositors from discriminating between institutions: companies and individuals alike want to avoid the hassle of having to retrieve deposits from a failed bank. There will be a bigger question to consider as well. Are there enough deposits to go round?

Too big to swallow

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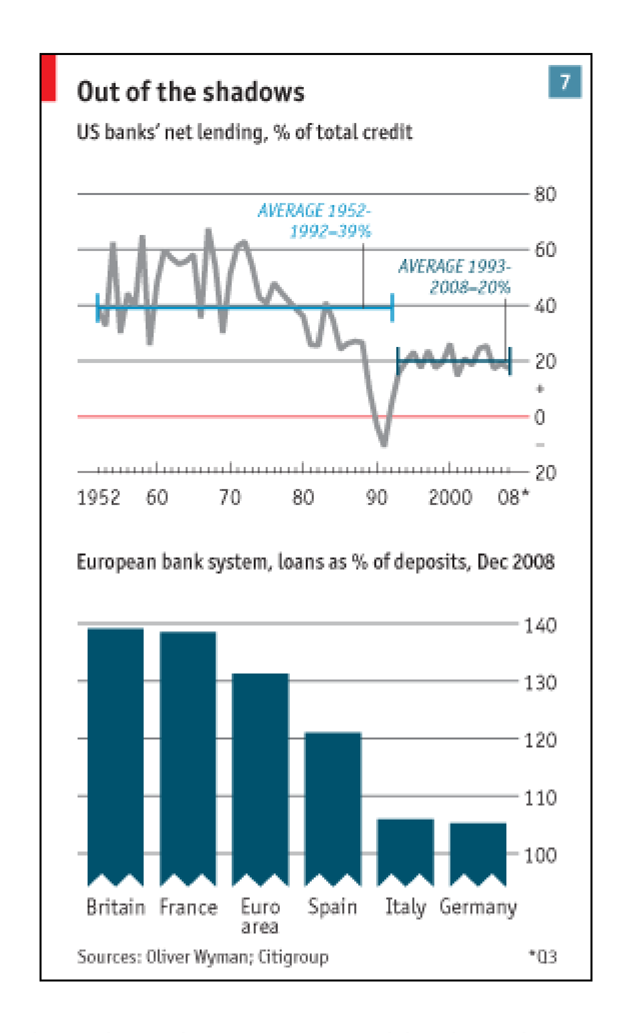
The future of securitisation is the industry's most pressing question

Illustration by R. Biesinger



ONE of the canards of the credit crisis, trotted out regularly by politicians and pundits, is that banks have stopped lending. It is a charge that bankers vehemently reject and the data largely back them up. It is true that overall flows of credit have fallen steeply. Yet analysis by Oliver Wyman, a consultancy, suggests that net lending by American banks, for example, has contracted by amounts that are broadly in line with previous recessions, when demand for credit naturally diminishes and lending standards inevitably tighten. Indeed the worry of some observers, given that easy credit got us into this mess, is that banks are still lending too much.

The really precipitous contraction in credit has come from non-bank lenders—the array of money-market funds, hedge funds, former investment banks, exchange-traded funds and the like that is sometimes called the "shadow banking system". These capital-market lenders are especially important in America—banks have supplied only 20% of total net lending in the country since 1993 (see chart 7)—but they play an increasingly important role elsewhere too.



In particular, non-bank lenders have been buyers of securitised products, loans that are bundled together into securities and sold on to investors. An estimated $8.7 trillion of assets worldwide are funded by securitisation. More than half of the credit cards and student loans originated in America in 2007 were securitised. Many European banks used securitisation to fund the expansion of their loan books in the boom (see chart 7).

There is a stylised model of what is meant to happen when the shadow banking system contracts, in which banks act as "lenders of second-to-last resort". Borrowers who can no longer get money from capital markets can call instead on contingent funding commitments made by the banks. And banks can fund their expanded asset base because at the same time deposits are attracted into the banks by the comfort of deposit insurance. A 2005 paper from Evan Gatev and Philip Strahan of Boston College and Til Schuermann of the Federal Reserve Bank of New York showed how this flight to traditional banking operated when the Long-Term Capital Management hedge fund failed in 1998.

Some of these things happened this time too. Liquidity lines from banks to off-balance-sheet entities such as conduits and structured investment vehicles (SIVs) were activated as securitisation markets evaporated. Bank executives report heavy loan demand as a result of the collapse in non-bank credit. Some savings flowed into banks too. The problem is that the amount of money needed from the banks this time around is so vast. Oliver Wyman calculates that in the first three quarters of 2008, lending via capital markets in America shrank (on an annualised basis) by $950 billion. In contrast, banks' total net lending in 2007 was just $850 billion.

Supposing for a moment that the banks actually wanted to take on the credit risk associated with these assets, the sums simply do not add up for two reasons. First, taking securitised assets back on to bank balance-sheets implies extra demand for capital that would be very hard for banks to meet in benign circumstances, let alone these ones.

Second, plenty of banks depend on securitisation for a big chunk of their own funding, so they would have to replace this source of finance with deposits. In most mature markets, savings penetration is already relatively deep, so there are limited options for driving deposits higher still. There is greater capacity to

increase deposits in emerging markets, where there is more cash under the mattress (see chart 8), but doing so takes years. “You cannot be disintermediated over ten years and then reintermediated in a month,” says Mr Nixon of RBC. Hence the near-universal agreement that securitisation needs to be revived.

Banking on the unbanked 8

Savings and investments as % of GDP, 2007

Savings / Investments

Source: Oliver Wyman

Resuscitation procedures

If only it were that simple. The intellectual case for securitisation certainly remains strong, and not just because without it, deleveraging will be even more painful. Banks that have concentrations of risk in their portfolios can reduce them by selling assets to other investors. Those investors who cannot extend credit directly to individuals or small businesses can get exposure to these assets via securitisation. “We didn’t come out of the internet bubble and say that we should give up on venture capital,” says a regulator.

Optimists point out that some of the worst excesses of the market have already gone. Ludicrously complex securitised products, the CDO-squareds and -cubeds, have gone forever. Greater emphasis on the quality of borrowers will mean that risk should become more predictable. “The problem comes when you start securitising things for which you cannot compute the odds of default,” says Stephen Cecchetti, chief economist at the Bank for International Settlements. Even if those predicted default rates are high, the risk can be mitigated by techniques such as overcollateralisation, where there is an excess of loans to cover losses.

There is also an emerging consensus on how to fix securitisation’s biggest flaw, the moral hazard which meant that originators had less incentive to care about the quality of the business they wrote because they thought the risks were someone else’s problem. By making issuers take the first loss on any defaults in the securitised pool of assets (and stipulating that they cannot hedge that exposure away), regulators will give them a clear incentive to think about asset quality.

This goal of aligning the interests of issuers and investors also explains official enthusiasm for covered bonds, a type of secured-funding instrument in which creditors have recourse to both assets and the issuing bank. By keeping all the assets on the balance-sheet, however, a surge in covered bonds would still require banks to find a lot of additional capital. That cost is more manageable if banks keep some exposure but sell most of the securities to other investors who have no recourse. Assume a risk-weighting of 20% on a portfolio of high-quality mortgages, calculates Jamie Dimon, JPMorgan Chase’s boss, and retaining a 10% slice of a $50 billion pool of mortgages would imply a capital charge of $80m. “That’s doable,” he says.

There is broad agreement on how a revived securitisation market would work (high-quality assets, simple products, some retained risk on the part of the issuer). But big worries remain. First, regulators may impose higher capital charges on banks for the contingent risks they run as a result of securitisation. Banks were not just undercharged for the formal liquidity lines they offered to conduits and SIVs; they were also undercharged for reputational risk, the informal obligation to reabsorb troubled off-balance-sheet assets to help their clients. That reputational exposure will surely attract a more explicit cost in future. Coming changes to FAS140, an American accounting rule for off-balance-sheet assets, will also mean that banks can no longer claim capital relief by securitising assets through special-purpose vehicles.

Second, many buyers of securitised products are also likely to be more constrained in future. Leveraged investors, such as some hedge funds, are going to find it harder to gear up, making the returns on securitised products less attractive.

Banks themselves, also important buyers of securitised products, will have less room for manoeuvre too.

Matt King, an analyst at Citigroup, believes that the surge in securitisation during the bubble can partly be explained by a massive mismatch between the regulatory regimes of American and European banks. Those American banks whose regulator imposed a leverage ratio had an incentive to move assets off their balance-sheets. European banks which operated only under a risk-weighted capital regime were able to buy those very same assets because they attracted a low capital charge. With risk weightings on the rise, and leverage ratios all the rage, the capacity of European banks to purchase these assets is shrinking.

Money-market funds, which invested heavily in securitised products, will also be more constrained. One of the most unnerving moments of the crisis was the massive outflow of cash from these funds after the announcement by one of them last September that it had “broken the buck”, meaning that its net asset value had fallen below $1 a share and investors were going to get less back than they had put in. With $3.4 trillion of assets under management, allowing a run on money-market funds was unthinkable. The American government stabilised the market with a temporary guarantee that investors would not lose money.

The issue is what kind of quid pro quo money-market funds will now face. There is a particular focus on their break-the-buck commitment, which means that they mimic a bank by engaging in maturity transformation while promising shareholders that they can get all their money back whenever they want it. A choice is looming for the industry—either to keep this commitment and submit to greater regulatory oversight, potentially including capital charges, or to drop it and make shareholders understand the risk.

Neither outcome is great for securitisers. If money-market funds keep the break-the-buck promise, they are likely to move into more liquid asset classes than securitised products. If they abandon it, they will demand even higher yields on securitised assets or even greater amounts of credit enhancement, which inevitably means higher borrowing costs for issuers. (On the flip side, if funds produce lower yields or more risk in future, that could lead investors to keep more of their money in banks).

Even for long-term investors—think of pension funds and insurers with long-dated liabilities of their own—likely levels of demand for securitisation are horribly murky. Rating agencies are going to be far more wary of giving AAA ratings for structured products. Since many of these investors have to put their money into top-rated products, that implies a smaller market.

When AAA ratings are awarded, investors will in any case derive less comfort from them. That is partly because of the high-profile failures of rating agencies and partly because investors are rethinking their assumptions about the supposed diversification benefits of securitised products. A large portfolio of securities clearly offers greater protection against idiosyncratic risk—the chance that a particular borrower will get into trouble—than buying a single-name corporate bond, say. But as a paper by Joshua Coval and Erik Stafford of Harvard Business School and Jakob Jurek of Princeton University argues, a diversified portfolio offers far less protection against systemic risk such as a general economic downturn. The chance of losses on securitised products increases as the economy worsens; for single-borrower bonds, firm-specific factors are more important than the economic climate. Growing awareness of this disproportionate exposure to systemic risk may reduce investors’ appetite for securitised products.

The uncertainties do not end there. Government intervention in America and elsewhere to ease homeowners’ repayment difficulties will shake investor confidence in future income streams. The prospect of court-ordered reductions in mortgage principal—or “cramdowns”—is particularly alarming. According to Anna Pinedo of Morrison & Foerster, a law firm, there is also fogginess around the tax status of securitisation trusts, the entities into which securitised assets are placed. For tax purposes, they are structured as “pass-through” entities, meaning that the servicing firms that administer mortgage payments have little scope to modify the terms of loans if borrowers get into difficulty. With servicers now given greater leeway to intervene, questions about how far they can go without compromising trusts’ tax status hang over the industry.

How these various uncertainties resolve themselves will not be known for years but two assertions look pretty safe. The first is that the market for securitisation will shrink substantially. Borrowers are scaling back, buyers are thinner on the ground, risk aversion is up and banks are in any case under pressure to improve their loan-to-deposit ratios. The second is that the extent of banks’ continued deleveraging depends to a large extent on the scale of that drop.

The wild card, of course, is the degree of long-term support that governments are willing to provide to buttress the market, whether through guarantees, loan programmes for investors or future incarnations of government-sponsored enterprises such as Freddie Mac and Fannie Mae. Whisper it softly, but one of

the lasting effects of this crisis could end up being institutionalised guarantees for buyers of securitised assets to sit alongside guarantees for retail depositors.



SPECIAL REPORTS

Opportunity gently knocks

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From The Economist print edition

Who will gain from the crisis?

DESTRUCTIVE? Absolutely. But will the financial crisis also be creative? When incumbents disappear and established business models no longer work, that is usually good news for up-and-comers. The massive disruption in banking has members of the industry's fringe rubbing their hands. They include:

Advisory boutiques. "Like gnats" is how an executive at a big investment bank describes boutiques. Without financing capacity, a global presence or big capital-markets businesses, they lack the firepower of bigger rivals. But the crisis has nevertheless increased their capacity to irritate the giants. Clients' faith in the advice of the industry's big names has been badly dented by their conspicuous inability to manage their own businesses. Many banks have damaged client relationships more directly, by skimping on credit as they slim their balance-sheets. Conflicts of interest for large banks are also more common now that their ranks have thinned. And boutiques have lots of high-quality job-hunters to choose from.

Peer-to-peer lending platforms. These websites, through which savers pool money and lend to borrowers, have also been boosted by the crisis. Derisory interest rates are encouraging savers to seek better returns elsewhere. Zopa, a British website that pioneered the concept, says the number of lenders joining it has soared. For borrowers spurned by their banks, low-cost and unleveraged social lenders are an attractive alternative. Zopa's boss, Giles Andrews, says new entrants like his should gain from how the crisis has undermined customers' faith in banks' solidity and intensified their doubts about whether the banks have customers' best interests at heart.

Islamic finance. This was booming before the crisis, thanks to oil-fuelled liquidity in the Gulf, rising devoutness among Muslims and a fast-developing market infrastructure. But its emphasis on risk-sharing and prohibition of speculation has a fresh resonance given the failures of Western finance. Its backers stress the ethical side of *sharia*-compliant finance. However, the Middle East is suffering its own economic headwinds and the industry's fundamental problems, including an over-reliance on short-term funding, have yet to be solved.

Supermarkets. They see the crisis as an opportunity to push further into financial services. Their costs of acquiring customers are low, because they already have millions of shoppers passing through their stores. Their brands are trusted. And those who have seen how retailers work with banks in joint ventures consistently note how much more focused grocers are on the customer's needs. "Retailers think first about the customer, banks about the profit," says an executive. Britain's Tesco announced an ambitious expansion of its banking activities in March.

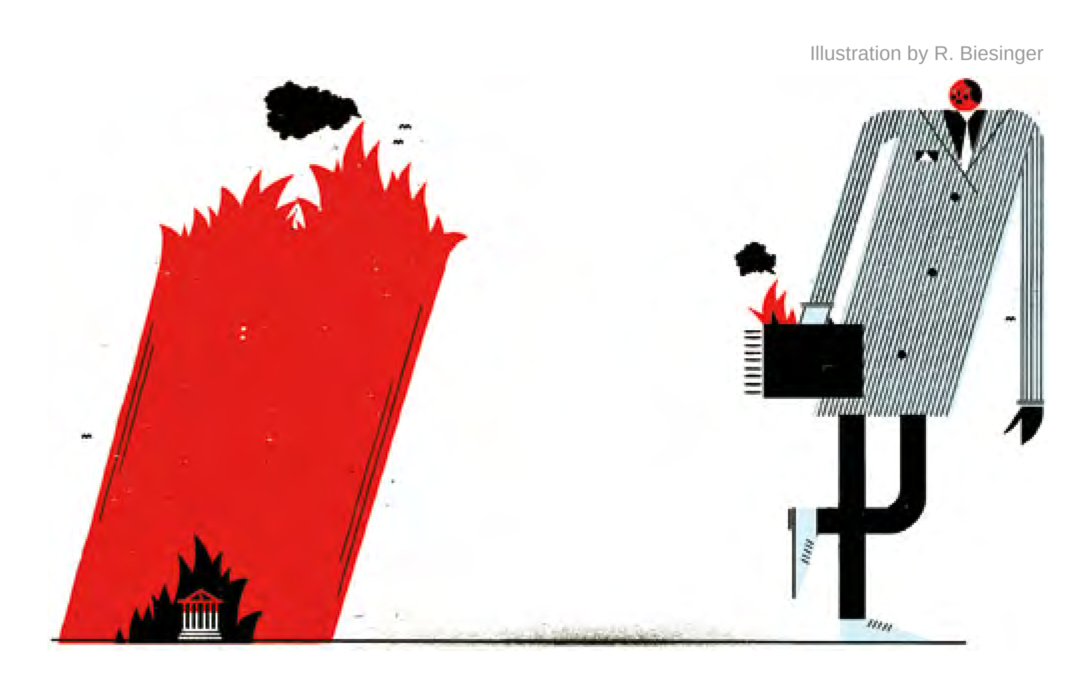
Just how capable non-banks are of taking big chunks of the market is unclear. The downturn is hitting most institutions, retailers included. Regulators will also have a big say. The rules may have been tweaked to make it more attractive for private-equity firms to invest in American banks, for example, but Douglas Landy of Allen & Overy, a law firm, expects continuing hostility to the idea of non-banks owning banks. And serious questions hover about whether it makes sense to encourage more competition in banking. "Anything that smacks of loosening regulatory standards is going to be politically hard," says Andrew Schwedel of Bain, a consultancy. There are great opportunities lying among the debris of the banking industry but reaching them may be tricky.

The revolution within

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The way banks manage risk—including how they reward managers for taking it—will change greatly

Illustration by R. Biesinger



THE changes to the environment in which banks operate—tougher regulation, higher capital requirements and scarcer funding—will have a dramatic impact on the way that banks are managed. But banks are also reflecting hard on some fundamental internal questions, such as how to manage risk, compensation and growth itself. Too many bosses and shareholders accepted years of double-digit returns without probing the sources and sustainability of those profits. “No one was asking the ‘Columbo’ questions,” says Toos Daruvala of McKinsey, a consultancy.

The most basic of these questions, particularly for banks with large wholesale operations, is what kind of businesses they want to be. The bubble was characterised by a game of copycat, in which banks strove to match the returns of their most profitable rivals by piling headlong into asset classes where they were lagging, irrespective of the risks. “The securities industry was based on revenue, not on risk-adjusted returns,” says a bank boss.

Consultants armed with league tables and presentations full of “gap analysis” increased the pressure on sluggards to catch up. Mr Winters of JPMorgan Chase recalls how executives at the bank worried about its underperformance in fixed-income markets. “We used to beat ourselves to death about it and wonder ‘what aren’t we getting right?’ Now we know.” For the foreseeable future, managers will think harder about where they have a competitive advantage over rivals, not where they don’t.

Besides working out what they are good at, banks must decide how much risk they want to take. Helped along by the ratcheting-up of capital charges in trading books and other planned regulatory changes, a sweeping shift in risk appetite is already under way. There are obviously distinctions between firms: Goldman Sachs has maintained a stronger bias towards risk exposure than Morgan Stanley, for example. But in general proprietary risk-taking is being scaled back drastically. Risk capital will reside outside the banking system, in hedge funds and private-equity firms, much more than before.

The likes of Deutsche Bank, UBS and Credit Suisse have all unveiled strategies to cut their proprietary activities in illiquid markets and focus on high-volume “flow” businesses: for example, helping clients to manage exchange-rate and interest-rate risk. That means leaving some moneymaking opportunities on the table, a most unbubble-like thing to do. “We could have held on to certain assets and made money now but we cannot have this kind of risk irrespective of future potential,” says Josef Ackermann, the boss of Deutsche Bank.

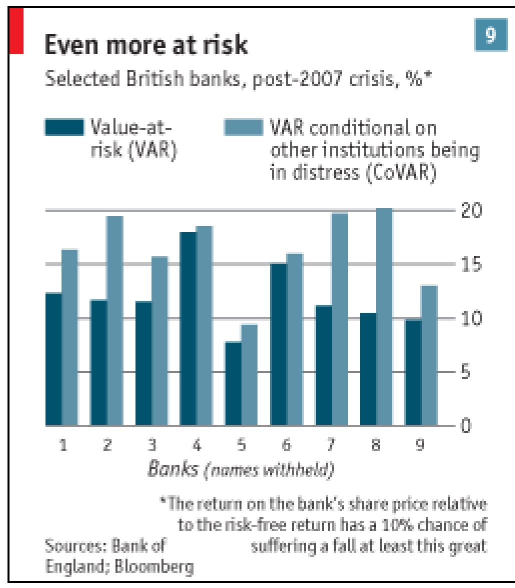
Fireproofing

Banks are also taking measures to ensure that a poor year in more volatile businesses cannot overwhelm a decent year in steadier ones. And they are reviewing the appropriate mix of earnings between divisions, given the capital-intensity and risk profile of some activities. The firewalls between businesses are being fortified, too, so that managers have a clearer idea of the standalone profitability of each division.

UBS was especially guilty of underpricing its internal funding, letting its investment bank take advantage of the bank's cheap overall cost of funds without paying an appropriate premium for the risks it was taking. The Swiss bank has reorganised itself to ensure that businesses are more autonomous and are funded at market rates. Such changes arguably have more impact than any regulatory reforms. "The real revolution will be within the businesses," says Charles Roxburgh of McKinsey, "as managers see real detail on who is making money and how."

The mechanics of risk management are also in upheaval. Articulating how much risk to take or deciding how much to charge internally for a certain activity is less clear now that many banks' risk models have proved unreliable. (The impression of additional uncertainty is itself partly illusory: the clarity models provided during the bubble was misleading.)

In truth, the crisis will make models more useful. They will be using data from a whole economic cycle rather than looking myopically at a period of exceptionally high returns. The improved risk profile of banks' borrowers also means they will have better data to work with. Methodological improvements will capture the relationships between institutions—the effect on its peers of Lehman Brothers going bust, say—as well as their independent risk profiles, which are commonly assessed by a measure called "value at risk" (VAR). Tobias Adrian of the Federal Reserve Bank of New York and Markus Brunnermeier of Princeton University have proposed a measure called CoVAR, or "conditional value at risk", which tries to capture the risk of loss in a portfolio due to other institutions being in trouble. Taking account of such spillover effects greatly increases some banks' value at risk (see chart 9).



Despite such improvements, risk managers are well aware of the need to beef up their qualitative controls too. Stress tests, designed to think through how institutions cope with periods of pressure, will become more important to boards as they seek to define institutions' risk appetite. They will also become more important to shareholders. Bank of New York Mellon has started to include figures in its earnings statements showing what could happen to its capital under various scenarios.

Stress tests will also become more demanding. Take the assumptions about how long liquidity can disappear for. Measures such as VAR seek to capture the effects of a single explosive event within a relatively short period. This crisis, says Koos Timmermans, chief risk officer of ING, a Dutch bank, has been "more like slow death by torture". Peter Neu of the Boston Consulting Group says stress tests must also become more "coherent". Too many banks defined stress events in isolation—asking what kind of losses they might sustain in the event of, say, a 20% stockmarket fall without asking what sorts of changes in the economic climate would prompt a fall that big.

Even Goldman Sachs, widely regarded as the best manager of risk in the industry, did not foresee quite how bad things could get. The bank's most demanding pre-crisis stress test—known as the "wow", or worst of the worst, test—took the most negative events to have happened in each market since 1998 and assumed that they got 30% worse and all happened at the same time. That still wasn't pessimistic enough.

Banks must revisit their assumptions about how effective their defences are against multiple risks. The crisis will live long in the collective memory for showing that all markets can become illiquid and all risks are correlated, removing many of the benefits of diversification. "The fourth quarter of last year was remarkable for showing how fragile the system has actually turned out to be," says Wilson Ervin, chief risk officer of Credit Suisse.

The inadequacy of specific hedges, something known as "basis risk", also came as a shock to many. A corporate bond and a cash-collateralised credit-default swap written on the same company ought to offset each other—if the company looks likely to default, the bond will fall and the swap rise. In late 2008 the system-wide evaporation of liquidity meant that banks could lose money on both.

A degree of calm has returned to the markets since then, reversing some of the losses banks suffered from basis risk. The amount of counterparty risk in the system will be reduced greatly by central clearing-houses for credit-default swaps. But confidence in hedges and market liquidity as a way of mitigating risk has been badly damaged. In response, banks will use a simpler set of palliatives. They will take greater account of their gross as well as net exposures. They will charge more for taking on risk on clients' behalf. And to the extent that they continue to package and sell securitised assets to investors, they will reduce the amount of inventory they hold.

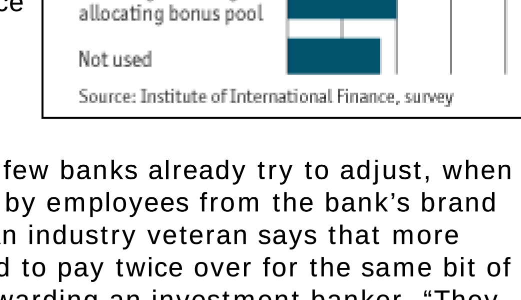
A game of pay sense

All of these aspects of risk management, from models to hedges, are important. But another risk-related question—bankers' pay—has dominated the public debate on the industry's failures. Pay has been the touchstone issue of the financial crisis, vilified both as the incentive that drove bankers to take foolish risks as well as the most inequitable feature of an industry that makes obscene profits in the good times and comes crawling to the taxpayer when it gets into trouble. From the bonuses paid to executives at AIG, a monumentally failed insurer, to the expensive tastes of John Thain, a former head of Merrill Lynch, and the huge pension granted to Sir Fred Goodwin, a former boss of RBS, pay has captured the public's attention, far more than the banks' many other failings.

Managers admit privately that things got way out of line. "It was better to be an employee than a shareholder," says a bank's chief executive. The traditional argument against changing pay structures has been that no institution could move unilaterally without competitors poaching its best people. Now, no bank can fail to alter its compensation policy without having its executives publicly humiliated by politicians and the news media, and frowned upon by regulators.

The broad thrust of the coming changes on pay is clear. Banks will tie compensation more closely to performance and spread rewards over longer periods. It should be said that neither idea is foreign to the industry. Bonus pools based on profits (though not revenues, an indefensible practice) may be seen as a problem now but are clearly more closely tied to performance than a fixed base salary. Awards of shares were common within the industry before the crisis and caused employees, those of Lehman Brothers included, to suffer vast losses when share prices dropped. What the industry as a whole did not do well enough was to design pay so that it better reflected long-term risk.

According to a survey of industry practices published by the Institute of International Finance (IIF) in March, many banks still fail to use risk-adjusted measures either to calculate the size of their bonus pool or to allocate it. That will change (see chart 10). Economic-capital models, which calculate the use of capital based on assumptions about expected losses, will be more widely used to set bankers' pay in future. The bonus/malus structure introduced by UBS in 2008, whereby a cash portion of a bonus award is held back at the end of a financial year and reduced if targets are not met in subsequent years, will also become more common as institutions seek to track and reward the performance of senior managers over time.



Some banks will be more sophisticated still. With costs and capital under so much pressure, the incentive for executives to identify those who add genuine value to a bank has rocketed. A few banks already try to adjust, when calculating bonuses, for franchise value—the advantage derived by employees from the bank's brand value, league-table positions and other institutional strengths. An industry veteran says that more managers of big banks will come to realise that they do not need to pay twice over for the same bit of business, first by building a global infrastructure and then by rewarding an investment banker. "They would get one in five calls for big projects anyway," he says.

Other ideas in the vanguard of designing pay structures include "S-curves", which pay less below a certain threshold of profit so as not to reward employees for market conditions and franchise value, but

also pay out less above a certain threshold, to discourage excessive risk-taking. These types of thinking are likely to become more prevalent.

Many of these changes are welcome, with two caveats. First, no system can be foolproof. Risk-adjusted measures of compensation work only if risk is being measured properly, for example, and the industry has proved how unsafe an assumption that is. And attempts to control pay in one area tend to inflate it in another. As bonuses fall, pressure on banks to increase basic pay is already rising. That pressure will grow as the industry recovers and competition for the best staff increases. “At some point in the next few years, the industry is going to have an absolutely stellar year,” says a pay consultant who predicts that firms with clawback policies will have to offer more in upfront pay to attract recruits. The second caveat is that some employees really are worth lots of money. Asked to defend levels of pay prior to the crisis, many in the industry would reach for the analogy of film or sport, two other industries where talented individuals are critical to success and are richly rewarded as a result. The trouble with this defence is that it was not just the big-name stars who got really rich in financial services; the extras did too. Lower profits and more sensitive pay structures will mean that most jobs are repriced across the industry but the best people will still be the subject of frenzied competition and will still command huge sums. That may be distasteful to many outsiders but if pay structures better reflect information about the risks such star bankers are taking and if their pay levels do not inflate the compensation of everyone around them, it ought to be defended.

The biggest upheavals in pay and in risk management will be in wholesale banking. The assumptions that underpin the way retail banks manage risks and pay have withstood the crisis better. There are still lessons to be learned, of course. One result, for example, will be that lenders demand more data on customers, leading borrowers to concentrate more of their business on particular institutions. But the basics of credit-risk management have been reinforced rather than overturned.

There is a problem with this picture, however. Retail banks may have less to change operationally (their funding profile is the obvious exception) yet they still got into a ton of trouble. The worst mistakes of this crisis were arguably made in relatively simple areas of retail and commercial banking—from the concentration of risk in the corporate-loan book of HBOS to Wachovia’s kamikaze acquisition of Golden West, a Californian lender stuffed full of mortgage-shaped grenades. Complexity is not much of an excuse here. For many banks, the crisis reflects a simpler tale of frenetic asset growth and the inevitable turn of the credit cycle.

And that raises a bigger management question—how institutions can resist the pressure to grow when a boom is in progress. Such pressure comes from all quarters: from shareholders who want growth, from analysts who want to see higher returns on equity, from staff who want bonuses, from managers who want to keep their jobs, and from politicians who want higher employment and tax takes. One way of getting around this is to operate in markets that offer high growth without requiring great risks. “We run a boring business model in exciting markets,” says Mr Sands of Standard Chartered, which is headquartered in London but operates in developing countries. “The problem was that others were running exciting business models in boring markets.”

Industry bosses agree that saying “no” to opportunity is one of their most important jobs and among their most difficult. Those who did sit out some of the boom were heartily criticised for doing so. Ed Clark, the boss of Canada’s TD, recalls the heat he got from analysts for exiting the structured-products business. Ulf Riese of Svenska Handelsbanken (see article) remembers the pressure that the bank resisted to join its peers in the Baltic lending boom. Mr Timmermans, the risk chief at ING, points to the problem of getting out of positions at the right time. “It is relatively easy to get discipline into the process of putting assets on to the books. The problem is when you have held them for two years and think it may be time to offload,” he says.

The governance gap

The memory of this most painful of episodes should make it easier for bosses to shake their heads, at least for a few years. Private capital will be more patient and managers will be more focused on sustainable growth rather than short-term returns on equity. Wrong-headed assumptions about risk dispersion will be less easily made. But there is an increasing recognition that the governance of financial institutions needs to be reviewed carefully (the British authorities have already initiated just such an exercise).

One obvious area of scrutiny will be the quality and composition of bank boards, which were found sorely

wanting in many cases. That does not mean that directors should take responsibility for risk management, a job for bank executives. “Directors do not design aeroplanes for Boeing or make the food for Taco Bell,” says Mr Dimon of JPMorgan Chase.

But it does mean that they can do a better job of vetting key executive appointments—for example, the rise of Chuck Prince, a lawyer, to head Citigroup and of Andy Hornby, a youthful former retailer, to lead HBOS should have prompted more searching questions. It means dedicating more time to reviewing the business, which implies a limit to the number of directorships that board members hold. It means separating risk and audit committees. It ought to mean dividing the role of chairman and chief executive. And it means asking more robust questions around such things as “key person” risk, in which only a few employees really understand what is going on in a particular line of business.

Profound questions are also being asked about the right model of bank ownership. Some fondly remember the old days of private partnerships on Wall Street. But for banks that need lots of money to operate, that is not an option. “Capital is like heroin,” says an investment banker. “Once you go down the capital-intensive route, you cannot go back.” Others promote the merits of mutuals, banks that are owned by their customers. Tony Prestedge of Nationwide, a British building society that has come through the crisis relatively well so far, says that being unlisted, mutuals can avoid being obsessed with short-term growth targets and can live with periods of reduced profits. Then again, Nationwide has spent much of the crisis snapping up other mutuals that have got into trouble, so the model is not infallible.

With quality of management being both the best defence against bank failure and something that can change with the appointment of a new chief executive or a rush of empire-building madness (step forward the managers of Bank of America and Lloyds TSB), regulators are likely to address the problem of governance in two different ways. The first will be to cushion the impact of those bank failures that do occur by creating better resolution regimes for large institutions and for non-banks. There are also proposals for banks to buy an option on capital via a kind of disaster-insurance scheme, paying out premiums to long-term investors in return for dollops of equity when crisis strikes.

The second direction of policy will be to intervene more forcefully to prevent failures in the first place, stepping in whenever asset growth accelerates, demanding a greater say in board appointments and vetoing dodgy acquisitions on the grounds of financial stability as well as competition concerns. More daring voices are even suggesting that there may be a case for an official presence at board meetings. There is at least time to get all of these things right. It will be a long time until anyone has to worry about the next bubble.

Back at the branch

May 14th 2009
From The Economist print edition

More Swedish lessons for the banking industry

IF A bank posts record results during the worst quarter in living memory for financial markets, it could be a quirk. When the same bank has produced higher-than-average returns on equity compared with its peers for a number of years, it deserves a closer look. And when it has a business model that appears to answer some of the main governance concerns afflicting the industry, it repays much wider attention.

The bank is Sweden's Svenska Handelsbanken, a retail bank with operations in Scandinavia, Britain and elsewhere. Handelsbanken posted a 39% quarter-on-quarter jump in operating profits in the fourth quarter of 2008. It has gobbled up great chunks of market share in deposits and new lending in the past year. The worst of the economic downturn is yet to come in Sweden but the bank has good reason to believe it can navigate stormy waters, since it sailed through the country's 1990s banking collapse unscathed.

The bank's managers put its success down to an extremely decentralised management model, introduced in 1972 after a period when Handelsbanken had got into trouble. Branch managers are the banks' main decision-makers, following what is known internally as the "church-tower principle"—namely, that you should do business only as far you can see from the local church tower. Responsibility for all credit decisions rests with the branches. No loans can be extended over the heads of branch managers (larger sums also require approval from higher up).

The bank is unimpressed by the idea of selling loans on to other investors. Ulf Riese, the bank's chief financial officer, says 30% of credit losses can be traced to the initial decision to extend credit but 70% come from changes in borrowers' circumstances and the way banks respond to them. Banks need to have deep customer relationships to spot and respond to these changes, he says. If loans do sour, Handelsbanken has no specialist central workout team, like those at many other banks, to come in and sort out the mess. The job is left to branches, which similarly have responsibility for cost management, salary levels and product offerings. A tier of regional management makes the decisions on where to open new branches.

The effects of making branches responsible for their own fate run deep. The bank's credit culture is consistent throughout the cycle, meaning that it loses market share in boom times and wins business in environments like this one. There are no formal budgets or projections for the year ahead, on the principle that customer needs, not product targets, should determine growth. Handelsbanken eschews bonuses too, on the grounds that they work against long-term relationships with customers and employees. If the bank meets its return-on-equity goals, however, a portion of the profits goes into the bank's pension scheme, which is its largest shareholder.

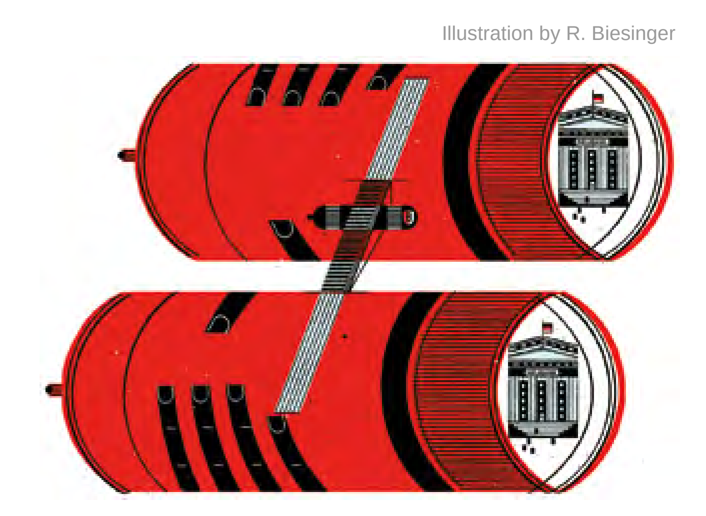
Is Handelsbanken just a Scandinavian oddity or can it teach others something? Its approach works in part because it is selective about the types of customers it takes on. A mass-market bank would find it tougher to copy its model and be profitable. Mr Riese reckons that the bank's initial shift to a decentralised model was helped by the fact that lending growth was very tightly regulated in Sweden at that time. Handing full control to branches would lead to more missteps in a deregulated market. But the bank's core philosophy—a focus on customers, not products; on profitability at the level of each operating unit; and on long-term relationships, not short-term gains—is clearly of its time.

From great to good

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From The Economist print edition

Banks will still make money, just less of it

Illustration by R. Biesinger



FUNDING markets are damaged. Borrowers have to recover from the biggest credit bubble in history. Bankers' reputations are mud. Regulators are not just reading riot acts, they are rewriting them. Yet many industry executives are surprisingly bouncy about the future. Investment bankers in particular have been sounding brighter, thanks to a healthy start to the year. Are banks in denial or do they have genuine cause for optimism?

The answer is obscured by a couple of big unknowns. One is the length and depth of the recession. A depressing analysis by Citigroup looks at what happened to banks in four previous episodes of extreme stress, including the Depression, Japan's "lost decade" in the 1990s and the Swedish banking crisis of the 1990s. Loan books collapsed in all cases (by 50% from peak to trough in America, 30% in Japan and 25% in Sweden), greatly reducing earnings even before credit losses were taken into account.

Direct comparisons are dangerous. Banks have fewer loans as a percentage of total assets nowadays (because they hold more securities) and they also have the chance to gain business that had been going to the shadow-banking system. But the dynamics that operated in earlier periods of stress are also present now—falling demand, pressure to deleverage to meet new capital rules and reduce loan-to-deposit ratios, and dipping asset values. European banks look especially leveraged in comparison with their American counterparts. If things turn out anywhere near as badly as before, says Simon Samuels of Citigroup, banks' pre-provision returns have a lot further to fall.

Another important unknown is the extent to which globalisation unravels. The threat of financial nationalism, sparked initially by political pressure on lenders to focus on domestic markets and reinforced by the likely tightening of rules on liquidity and capital for any bank operating within a country's borders, is arguably the biggest long-term worry for international banks. (Local banks, by contrast, should find it easier to win more business.)

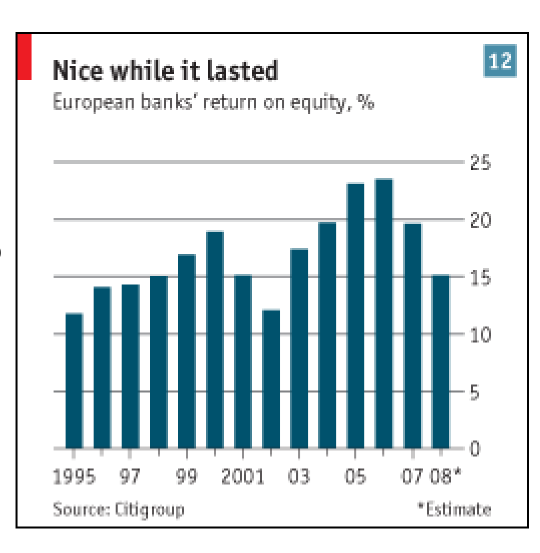
Business volumes are likely to fall in markets that have been producing a rising proportion of revenue at the big banks (see chart 11). Returns will drop if banks have to set aside more capital at the national level, or fund themselves from domestic deposits. Big customers may take things into their own hands if the system gets too fragmented. "If international banking gets more difficult, multinationals will end up doing things like cash management themselves," says Mr Sands of Standard Chartered.

Let us again make some non-apocalyptic assumptions: that the business of international banking is less profitable but survives

broadly intact and that the recession reaches a bottom in the relatively near future. That still leaves many banks with the task of finding a new set of profit drivers to replace the old ones.



The extraordinary returns on equity that banks enjoyed in recent years (see chart 12) were largely created by leverage, the ability to increase the amount of assets they held relative to their equity, and by "asset velocity", which let banks reuse capital multiple times during the course of a year as assets were originated and speedily moved off balance-sheets through securitisation. The new emphasis on stability of capital and funding ensures that neither source of profits will be readily available to banks in the future. The banks' hope is that they can compensate by increasing their unleveraged returns, which means grabbing higher volumes of business and repricing their products.



They do have some cause for optimism. The structural potential of developing markets remains intact. And in mature markets, banks' financing and risk-management capabilities are arguably in greater demand than ever. Lots of companies still need to raise capital, for example, as evidenced by the rush of bond issuance in the first two months of the year. The advisory business is ticking over too, as waves of companies seek to restructure debts.

Still hedging

Many expect clients to demand more hedging because of the crisis. "There are companies that cannot continue operating today as a result of a failure to hedge," says Mr Winters at JPMorgan Chase, who also reckons that clients will ask for more precise, and therefore expensive, forms of protection given the inadequate performance of some hedges through recent months. "If you are exposed to real estate in the [English] Midlands it is no good being hedged with a European property index," he says.

A heightened awareness of risk will affect clients' relationships with the banks themselves. Banks are supposed to worry about borrowers going bust. Now the reverse is also true. Mergers and acquisitions mandates often require companies to pay banks a fee even if they are no longer involved at the time a deal is done, for instance. Some clients now want engagement letters for the services of banks to spell out what would happen if the banks failed in the interim. The bankruptcy of Lehman Brothers gave a harsh lesson to hedge funds about the dangers of doing all of their borrowing and saving with a single prime broker. Custody banks are winning lots of hedge-fund business as a result of this. Tri-party collateral management, whereby a third bank acts an intermediary between a buyer and seller, is another growth area for custodians. Bank of New York Mellon is currently servicing $1.8 trillion of tri-party collateral a day, up from $1.2 trillion in 2007.

Trend-watching

Changes in consumer behaviour can also create opportunities for retail banks. A shift towards saving is one trend to capitalise on. Retail bankers are already thinking about structured savings products that offer consumers the chance to start putting money back into shares while protecting their principal. Given worries about the stability of the dollar, says David McKay of RBC, there will also be greater demand for products denominated in other currencies such as the euro.

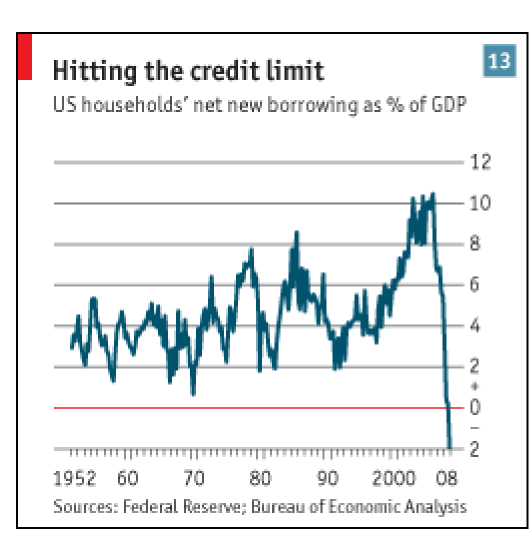
More important is the fact that competition has fallen sharply in many markets, either because banks have disappeared or because they are financially and politically constrained. The credit environment has changed from being demand-driven to supply-constrained, which means that market share is up for

grabs and pricing power has increased markedly. A recent report on the future of wholesale banking from Morgan Stanley and Oliver Wyman reckons that bid-offer spreads have increased by anything from 50% to 300%. “The change in the competitive landscape has been absolutely brutal but for the winners, volumes are up, margins up and market share up,” says Mr Varley of Barclays.

Survivors of the crisis will also be protected by higher barriers to competition. Regulators are going to be nervier about letting new entrants into the finance industry and allowing foreign banks free rein in their markets. Many of the most important sources of earnings in the new banking landscape, such as cash-management services and flow businesses, are gigantic, technology-heavy operations that are difficult to replicate. Economies of scale will also count for more in areas such as deposit-gathering, risk analysis, cross-selling and wholesale-debt issuance. Although there is much talk about constraining banks that are too big to fail, the smallest institutions are the ones that will suffer most in this changed environment.

All of these factors help to explain why banking will continue to be a highly attractive business. But they do not make up for what has been lost. Huge swathes of the wholesale industry’s product offering (including some of its most profitable areas) have disappeared. So have many of its newer customers—analysts at Morgan Stanley reckon that hedge-fund assets fell by around 40% in the second half of 2008 alone, and that a further 15-30% of assets will be redeemed this year. The contribution that prime brokerage, structured credit and private-equity activities made to profits in wholesale banking rose from approximately 20% in 2000 to around 35% in 2006, according to estimates by Oliver Wyman. These sources of revenue will not easily be replaced.

The goal of many retail customers, meanwhile, will be to deleverage. The fact that households, not businesses, have so much debt to unwind is something that marks this episode out from many previous banking crises. According to McKinsey, American consumers have accounted for more than three-quarters of the country’s GDP growth since 2000 and for more than one-third of worldwide growth in private consumption since 1990. Although deleveraging can also occur through income growth, the immediate response of consumers has been to save more, depressing demand for credit (see chart 13). That is likely to continue for the foreseeable future. (The situation in emerging markets is different: assets there will probably grow rapidly again once the economic cycle turns, although the need to reduce loan-to-deposit ratios will weigh on several eastern European markets.)



The ability of retail banks to make money from those customers who do still need to borrow is also more constrained than it may appear. The politics of ramping up lending rates to taxpayers is sensitive, to say the least. As Andy Maguire of the Boston Consulting Group points out, there is also an adverse-selection problem. Borrowers who are applying for credit right now are likely to be the ones that are having trouble getting loans elsewhere. Moving existing customers on to higher-priced loans prematurely can strain relations.

Nightmare scenario

Low interest rates have steepened the yield curve, the difference between short- and long-term rates, but they also make this a terrible environment for deposit margins, which banks calculate as the difference between what they pay for deposits and what they make by putting them to work in money markets. With interest rates so close to zero, banks are having to cut their lending rates but have no room to drop their deposit rates further. Spreads compress as a result. “The nightmare scenario is a period of extended low interest rates like Japan,” says Mr Clark of TD.

There is another threat to profits. Banks make money not just from the spreads they can command on lending but also from fees. The politicisation of banking could easily mean that the fairness of bank fees comes under closer scrutiny. Britain’s Office of Fair Trading has already ruled some bank charges unfair. American lawmakers are taking aim at credit-card fees in a proposed law. With voters, ie, consumers, now in charge of the industry, other fees such as overdraft charges may also fall under the spotlight. Offshore banking secrecy is an example of something that did not cause the crisis but has been vigorously targeted in its aftermath.

Wealthier clients are also likely to be less inclined to pay fat fees in such businesses as asset management, as falling markets, frauds such as the Bernard Madoff scandal and broken promises of absolute returns make investors question the value they are getting. As the full effect of the crisis on savings and pensions becomes clearer, consumer activism is likely to rise.

A glistering era ends

Add to this picture the drag of continuing losses from toxic assets and souring loans, and it is clear that as an industry, banks are going to find it much tougher to make money than before. Clearly, costs, particularly those related to pay, will fall as well as revenues. But there seems to be broad consensus among industry observers that average returns on equity through the economic cycle will be in the low- to mid-teens henceforth, well down on the 20%-plus achieved before the current crisis.

Another way of looking at the industry is to compare its growth with GDP growth. In emerging markets, the industry should still be able to grow faster than GDP as the use of financial products spreads. In mature markets, with the turbo-boost of leverage gone and bank balance-sheets still to be slimmed, a growth rate in line with GDP is probably as much as can be hoped for. That would still make banking a decent business, comparable to many other industries. And if you look at returns on a risk-adjusted basis, as some converts to the cause now urge, it may even be a more profitable one than before. But masters of the universe it ain’t.

It is possible to glance at the emerging landscape of banking and think that not an awful lot is going to change. Aside from a few tweaks to capital here, some tougher rules on liquidity there, and the disappearance of a handful of badly-run institutions, the same big names dominate the industry. And yes, banks will make less money than before but the industry will still return decent profits and still pay its people well. Their first-quarter earnings showed that they can generate huge amounts of money in even the most difficult times. With so many assets trading at such distressed levels, many expect the wholesale side of the industry to record massive gains when sentiment properly turns around.

Regulators themselves wonder whether the measures now being discussed go far enough. As Mr Borio at the Bank for International Settlements points out, many of the ideas around countercyclicality (setting aside more capital in good times) and macroprudential regulation (safeguarding the stability of the whole banking system as well as of individual banks) were oven-ready, having been worked on by a coterie of central bankers, academics and regulators for a number of years. Calls to dismantle the biggest institutions and split up universal banks have not got far.

Yet the scale of the change sweeping over banking should not be minimised. Banks will seek to conserve capital, not find ways to run it down. They will cut their dependence on wholesale funding, and grow more slowly as a result. They will manage risk, not assume it away. Staff and lines of businesses will have to show they add value to a bank, not just increase its revenues. Regulators will bare their teeth more, and look away less. And taxpayers, whether explicit owners or implicit guarantors, will peer at the industry and its leaders with hostility, not admiration.

As dramatic as these changes will be to those inside the banks, they will be just as striking for banks’ customers. During the bubble and during the crisis, credit was tidal. It swept in, buoying everything from subprime mortgages to leveraged buy-outs. And then it swept out again, stranding everyone from investment-grade companies to emerging-market oligarchs. In the future, credit will be riverine. It will stream towards more creditworthy borrowers. It will follow a more defined course, constrained by embankments of capital, funding and risk management. Its flow will be more domestic, less global. Above all, it will be scarcer.

Given what has gone before, that may seem like no bad thing but it will entail costs. No one knows exactly what the right balance of debt and equity is in an economy, but the shrinkage of securitisation in particular makes it more likely that the process of deleveraging will overshoot. Customers, such as new businesses or immigrants, who lack a credit history but could well be terrific economic bets will find it tougher to raise money. Emerging markets that need to wean themselves off cross-border capital will grow more slowly than their potential. For borrowers such as these, the failure of the banks will not be measured in periods of a few dramatic months. Its legacy will last years.

Sources and acknowledgments

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Offer to readers

May 14th 2009
From The Economist print edition

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Corporate social responsibility

A stress test for good intentions

May 14th 2009 | LONDON AND SAN FRANCISCO
From The Economist print edition

The recession is a test of companies' commitments to doing good

Illustration by Claudio Munoz



IN JUNE Gap, a big retailer based in San Francisco, will hold a strategy meeting for its corporate social responsibility (CSR) team. In previous years that meant flying in people from 20 countries around the world. But this time the company plans to bring them together virtually, via online meetings. The main reason for the switch is not to help save the planet by reducing Gap's carbon footprint, but to help save money. "Everyone's looking to become more efficient," explains Dan Henkle, who leads the company's CSR activities.

As firms grapple with a brutal economic downturn, they are taking a long, hard look at the resources they devote to everything from supporting charities to making their activities carbon-neutral. That is hardly surprising: cutting back on CSR, or "sustainability" as it is sometimes known, would seem to be a quick and relatively painless way to save money. Cassandras who felt many CSR initiatives were little more than publicity stunts in the first place predicted that they would perish as soon as the economy fell off a cliff.

There have indeed been cuts to CSR budgets. A survey conducted late last year on behalf of Business for Social Responsibility, a global network of firms with an interest in CSR, showed that almost a third expected their spending on sustainability to fall as a result of the crisis. Yet so far the recession has not produced a wholesale retreat from corporate do-gooding. Instead it has led firms to cut things that were at best peripheral to their business interests and, at worst, a waste of time and money.

Most of the cuts have been to corporate-philanthropy budgets, which typically fund charities and NGOs. For instance, Citigroup's charitable foundation says it expects to make $63m of grants in 2009, down from $90m last year. The bank says it had already planned to focus its giving in fewer strategic areas before the financial crisis broke and that it is still investing heavily in CSR-related initiatives across its businesses. Given the woes of Citigroup and some other troubled financial institutions, taxpayers might question why banks are still forking out any cash to good causes rather than using it to repay government loans. Yet bankers argue that scrapping such activities altogether would be extremely damaging to their reputations and profits—or, at least, what's left of them. Carmakers are also cutting back. Ford expects its philanthropic arm to shell out 40% less this year, but says it remains committed to the principle of

corporate giving.

The downturn has dented other aspects of CSR, too. While businesses were minting money, there was much talk of “green” travel and offsetting carbon footprints. Yet a survey of 329 corporate-travel managers and business travellers published in February by the Association of Corporate Travel Executives found that only 17% of them now ranked environmental sustainability as a high priority, compared with 29% a year ago. The silver lining in this carbon-filled cloud is that executives at firms such as Gap are using technology to cut the number of trips they make in order to save money. Accenture, a consultancy, reckons it has saved $8m in a year by using “telepresence” systems and has avoided journeys that would have generated 2,000 tonnes of carbon dioxide.

But chaos in the global financial system has stymied some big, environmentally friendly projects. American Electric Power (AEP) chose to delay its plans to build a wind farm in Indiana when the heavily indebted utility found its cost of capital had soared because of turmoil in the corporate-bond market. The firm is now exploring other ways of meeting the ambitious targets that it has set for generating energy from renewable sources.

AEP’s commitment to greenery is not driven by rose-tinted altruism: it expects demand for clean power to increase as a result of government actions to limit climate change. Other firms are sticking with green-energy projects because they can boost efficiency or cut costs. Intel, the world’s largest chipmaker, says it plans to increase investment in energy efficiency this year because the $23m it has poured into green energy since 2001 cut its fuel bills by $50m over the same period.

Self-interest also explains why many companies are intent on creating greener supply chains, in spite of the costs. Mars and Cadbury, two confectionery-makers, have separately announced plans to increase the amount of cocoa they source from sustainable sources because both are concerned about future shortages if production practices do not change. IKEA is also fretting about one of its most important raw materials. The Swedish furniture giant has agreed a plan to increase the amount of wood in its products that comes from responsibly managed forests between 2010 and 2012.

So the preliminary results of the CSR stress-test are encouraging. Many firms really do seem to have found ways of making the world better while making money at the same time. A few, such as America’s GE, have built entire business models around sustainability. This month Jeff Immelt, GE’s boss, unveiled a $6 billion plan to help its health-care division increase its profits while broadening people’s access to low-cost health care around the world.

Another reason for optimism is that consumer interest in companies’ sustainability credentials remains strong in spite of the recession. Consumers’ consciences have “not been put on hold,” notes Simon Propper of Context, a CSR consultancy. Nor have employees’. Many firms have spent a great deal of time getting staff involved in sustainability. Any backsliding would probably damage morale.

It would also damage a firm’s chances of recruiting future stars. Gap’s Mr Henkle says the college students he meets these days are far more informed about sustainability than their predecessors. Firms that can show they stuck to their sustainable ways during the recession may find it easier to attract the brightest talent when the economy recovers.

There is one other important reason for thinking that companies will maintain their commitments to sustainability through the downturn and beyond: the need to restore confidence in business. The financial crisis was triggered by a bout of corporate social irresponsibility on a massive scale that has tarnished the reputations of even the bluest of blue-chip companies. Now corporate leaders have a chance to show that they are not just motivated by short-termism after all.

Intel's antitrust ruling

A billion-euro question

May 14th 2009
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Are the chipmaker's pricing policies anticompetitive?

IN THE end all that seemed to matter was the size of the fine. When it was announced on May 13th it turned out to be the largest ever of its type: €1.06 billion ($1.44 billion). This is what Intel, the world's biggest chipmaker, will have to pay if the European Commission prevails in its view that the firm, which sells about 80% of the microprocessors for PCs, has abused its dominance.

Yet the case against Intel is not chiefly about money that might one day "sponsor the European taxpayer", in the words of Neelie Kroes, Europe's competition commissioner (the fine will sit in a blocked bank account until the case is decided). The main question is: under what conditions can a quasi-monopoly such as Intel give discounts and rebates to computer-makers and retailers?

The commission does not think that such practices are illegal *per se*. But it claims that Intel's discounts and rebates were often conditional on the exclusion of its rival, AMD. The commission says that in one case Intel paid Media-Saturn Holding, Germany's largest electronics retailer, to sell only computers with Intel chips inside, and in another case a computer-maker had to agree to buy at least 95% of the chips in its business PCs from Intel to qualify for rebates.

Computer-makers have to play along, the commission argues, because they depend on Intel for a majority of their chips—a result of the fact that AMD's production capacity is limited. If a firm decided to buy as many AMD chips as possible, it could end up worse off since it might then have to pay more for the chips purchased from Intel. To overcome this handicap, AMD would have to price its processors below cost, and perhaps even pay its customers. In one case, according to the commission, AMD offered a computer-maker 1m free chips, but it ended up taking only 160,000 of them.

Intel says the claims against it are false. It does not deny making extensive use of discounts and rebates, but insists that it has never required customers to agree not to buy from AMD in order to obtain a discount, and has never raised prices when customers bought from AMD. What is more, says Bruce Sewell, Intel's general counsel, no harm seems to have been done: AMD is alive, chip prices are falling and innovation is rampant.

Intel says it will appeal to the European Court of First Instance. In the meantime, both sides will argue over the evidence in this week's 524-page decision. In the end, whether Intel is found guilty may be less important than whether the case establishes clear rules about what dominant firms are allowed to do.

Porsche and Volkswagen

Payback for Piëch

May 14th 2009
From The Economist print edition

Only now is the extent of Porsche's defeat becoming apparent

Alamy



Piëch in the driving seat

IF THERE is one certainty in the European car industry it is that it does not pay to cross Ferdinand Piëch, the 72-year-old chairman of Volkswagen (VW). This week, in bullish mood at the launch of the new VW Polo hatchback in Sardinia, Mr Piëch declared victory over the Porsche family and Porsche's headstrong chief executive, Wendelin Wiedeking.

After reaching an agreement on May 6th to call off Porsche's improbable attempt to take over VW, a company 15 times its size, the Porsche and Piëch families, who control 100% of the voting stock in Porsche Automobil Holding, gave themselves four weeks to hammer out the terms and structure of a merger between the two firms. But Mr Piëch, who personally owns 10% of Porsche, has now made it quite clear that it is he and VW that are in the driving seat and not, as seemed likely only a few months ago, his cousin, Wolfgang Porsche, or Mr Wiedeking. The final shape of the merged group has yet to be fixed, but Mr Piëch dropped some pretty broad hints.

Although there are supposedly two other options still on the table, it looks almost certain that Porsche will be fully integrated into the VW Group, joining its seven other car brands—VW, Audi, Skoda, Seat, Bentley, Lamborghini and Bugatti. And it will be the chief executive of VW, Martin Winterkorn, who will run the show. A gloating Mr Piëch said that he "could not imagine" Mr Wiedeking would be willing to become a mere divisional chief within the merged company, as a man used to "marching through" his career "would have to climb down very many stairs" and practise "humility".

Nor could Mr Piëch imagine VW taking on the €9 billion ($12.2 billion) debt that Porsche racked up acquiring its 50.8% in VW. And as for giving a senior job to Holger Härter, Porsche's once-feted chief financial officer—well, the joint-architect with Mr Wiedeking of the attempt to win control of VW must now shoulder the blame for the consequences of its failure.

More than two years in the making, the two men's bold plan unravelled in a matter of weeks. At the end of last year Porsche's strategy still seemed on course. In October the company triggered a sensational squeeze on short-sellers when it was slow to admit that it had raised its stake in VW voting shares to 42.6% and had acquired a further 31.5% in the form of secured options. In late November, announcing record profits that exceeded revenue, thanks to a €6.83 billion gain in the value of its VW shares, Mr Wiedeking confirmed that he wanted "dominant control" of VW and would use a €10 billion credit line to realise the options.

It never happened. Three things thwarted Porsche. In January the firm increased its stake in VW to its present 50.8%, almost tripling its net debt to €9 billion in the process, just as sales at Porsche's car business were tumbling—leaving less cash to pay the interest on the debt. Second, conditions in the credit

markets made it harder to go on borrowing more. On March 24th Porsche was able to roll over its existing loan only by pledging its VW shares to the banks and promising to pay back €3.3 billion within six months.

Third, Porsche was counting on the repeal of the so-called Volkswagen Law that restricts individual shareholders to 20% of the voting rights, regardless of the number of shares they own, and gives the state of Lower Saxony a veto on major decisions. The law's abolition would have allowed Porsche to use its anticipated 75% stake in VW to get its hands on the bigger company's cash reserves, which stood at €10.7 billion at the end of the last quarter.

But despite a recent amendment by the German federal government, the law still guarantees Lower Saxony's veto. The state's premier, Christian Wulff, sees Porsche as an opportunistic would-be plunderer. With his support and that of Bernd Osterloh, the head of the powerful VW works council, Mr Piëch feels he is in a position to dictate terms to Porsche.

The trickiest matter to be settled is Porsche's debt, which Porsche wants to reduce by at least €5 billion. Mr Piëch says he opposes selling a stake in Porsche to an outside investor. Yet he is adamant that VW will not absorb the debt for fear of damaging its own credit rating. That leaves two alternatives. Either the two families will have to dig into their pockets, or VW will simply buy Porsche's car business—Adam Jonas of Morgan Stanley values it at €5 billion-€6 billion on a stand-alone basis—leaving the holding company as a purely financial entity. Both options would give Mr Piëch what he wants: uncontested control of the world's second-biggest car firm and sweet revenge.

Television in Spain

Zapped

May 14th 2009 | MADRID
From The Economist print edition

A plan to banish advertising from state-run television proves unpopular

GIVEN that Spain is wrestling with a deep recession, reorganising the financing of state television hardly seems a priority. Yet on May 8th the government approved a plan to do just that. It hopes to impose a total ban on advertisements on Televisión Española (TVE) by September.

The government justified its hurried decision by pointing to the sharp fall in television-advertising revenue, which it said threatened to upset TVE's finely balanced finances. In 2008 advertising brought in €557m ($815m), or about 50% of TVE's total budget. The rest came from government subsidies, but these were not enough to prevent a €72m loss for the year. Borrowing the approach taken by France, which is also banning advertising from state-owned television, the Spanish government plans instead to fund TVE by imposing new taxes on private broadcasters and telecoms operators.

Yet if TVE's finances look poorly, its private competitors may be in even worse shape. Paolo Vasile, chief executive of the largest private broadcaster, Telecinco, recently accused TVE of bidding too high for content rights and charging too little for advertising. Uteca, a Spanish broadcasting association, says TVE charged 30-40% less than Telecinco for advertising in April, even though it has a larger audience. Telecinco's audience share and earnings are expected to drop this year.

Surely the commercial stations stand to benefit as advertisers shift their spending from TVE? Alas, the French experience suggests otherwise. France abolished advertising in prime time on state-run channels in January, and will phase it out altogether by 2011. But that did not stop France's main commercial station, TF1, from suffering a 27% drop in advertising in the first three months of the year. Advertising revenues at M6, another private station, fell by 11%. Worse, the private firms have to pay a 3% tax on their revenues to subsidise state-run television—a model Spain intends to copy.

Spain's private broadcasters may not benefit from an increase in advertising revenue, but the government has introduced other measures to help them. There will be limits on how much TVE can bid for sports and film rights, and rules on industry consolidation are being relaxed. But the benefits of these moves will not be immediate.

Advertisers, for their part, are unhappy that they will no longer be able to advertise on TVE. Spain's advertising association says this will dampen consumer demand and further weaken the economy. Viewers, meanwhile, like the idea of TVE being free of advertisements, but worry that they will end up paying in other ways. In addition to the 3% tax on broadcasters, Spain plans to emulate the French scheme of levying a 0.9% tax on the revenues of telecoms operators, equivalent to about €400m a year, on the dubious basis that they earn "billions". Redtel, a lobby that represents the largest operators, says this tax is illegal and amounts to an "incomprehensible" subsidy of another industry. Operators might simply pass the cost on to Spain's mobile-phone users.

The government says viewers will benefit from higher-quality programming. But that is questionable, too. Like the French, the Spanish seem to consider Britain's BBC, which has no advertising on its domestic service, as a model. Yet the BBC chases ratings to justify the levying of a tax on every television. Its prime-time schedule is packed with reality TV and soap operas.

Insiders at TVE say they are worried that the new restrictions on it will reduce its audience share, making it difficult to justify its large workforce. TVE will have to work fast to reinvent itself in response to the new guidelines. Introducing the advertising ban in phases, as in France, might help. As it stands, the government's move seems to have pleased hardly anybody.

Advertising's new model

Clock-watchers no more

May 14th 2009 | NEW YORK
From The Economist print edition

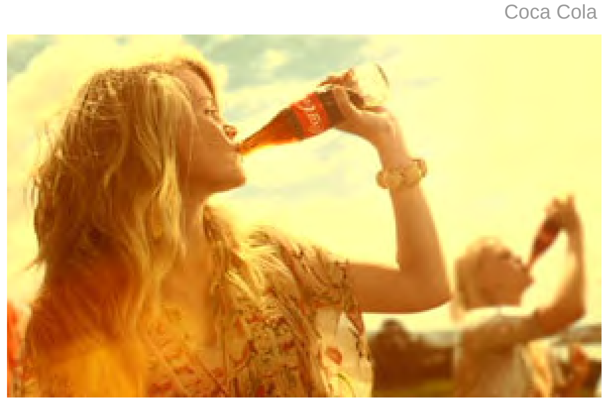
A movement to pay advertising agencies for value, not hours, takes off

EMMA COOKSON, the boss of BBH, a global advertising firm, says her industry has been "approaching and avoiding" a change in how it is paid for many years. Avoidance, however, may no longer be an option. On April 20th Coca-Cola said it would adopt a "value-based" compensation system for the advertisers that do work for its 400 brands. Rather than paying advertising agencies for hours worked, Coke will pay for results achieved.

The industry, already sick because of the recession, turned a bit bluer in the face at the news. Global ad spending is expected to decline by nearly 7% in 2009, according to ZenithOptimedia, and by around 9% in America. Carmakers and other faltering firms have cut marketing budgets, and work is harder to come by. There have been lay-offs. It is hardly an opportune time to discuss a change in compensation models. Billable hours have been the standard way of doing things since the 1970s. Assessing a campaign's value is much harder.

Coke, however, thinks it can do just that. Its new model guarantees to cover advertising agencies' costs, plus a bonus of up to 30%. The bonus depends on a number of metrics, including the agency's overall performance, and the sales and market share of the products being advertised. Coke insists that its aim is not to cut costs but to inspire creativity and efficiency. Procter & Gamble, a consumer-goods giant which has also ditched hourly fees in favour of performance-related fees for 12 of its brands, says the same thing.

Coca Cola



What is it worth?

Although the recession may give companies an immediate reason to reassess how they pay their advertising agencies, it is not the sole impetus for the switch. Discussions about finding better ways to reward agencies for their creativity have been going on for years. The American Association of Advertising Agencies estimates that about 10% of compensation agreements are value-based. Coke's announcement of its new approach will probably spur other firms to follow suit, and Coke has said that it wants its model to become the standard for the industry.

The shift away from the billable hour, however, may take a while. Some agency executives are sceptical about being paid for value, because it is so subjective. They interpret talk about value as code for cost-cutting. Jeff Goodby, co-founder of Goodby, Silverstein & Partners, an advertising agency, dislikes the fact that Coke's new policy guarantees only recouped costs. If he is going to take on a project in which he assumes risk by not knowing his profit margin in advance, "There has to be a big pot at the end of that rainbow," he says.

But some advertising agencies have voluntarily moved away from billing by the hour and towards contracts that reward value. Jeff Hicks, chief executive of Crispin Porter + Bogusky, says this approach

has helped his agency work more closely with clients by aligning the agency's compensation and the advertiser's profitability. Others, sensing the limitation of being paid by the hour, are trying to develop new ways to capture the value their work can create. For example, BBH recently launched a unit, called Zag, which designs and markets its own products, such as ready-made foods.

Advertising is not the only industry where there is discussion about whether to pay for time or results. Some accounting, consulting and law firms are also scrapping the billable hour, often at the request of their clients. Ron Baker, author of "Pricing on Purpose", a book on pricing strategies, thinks service agencies need to grasp that they sell ideas, not time, and that ideas should be generously compensated. Imagine, he says, if J.K. Rowling had been paid by the hour to write about Harry Potter.

Telecoms in Australia

So long, Sol

May 14th 2009 | SYDNEY
From The Economist print edition

Telstra finally calls an end to its long fight with the government

ONCE a byword for state-run inefficiency, Telstra is now famous instead for corporate belligerence and executive arrogance. For many years the Australian telecoms giant, under its American chief executive, Sol Trujillo, was at war with regulators and successive federal governments over its plans for a high-speed broadband network. The resulting conflict resulted in grievous self-inflicted harm, not least feet peppered with buckshot.

In February, after nearly four turbulent years in charge, Mr Trujillo said he would stand down at the end of June, a year earlier than scheduled. On May 8th Telstra announced the resignation of its chairman, Donald McGauchie, who had backed his bruising style. The board has appointed two more conciliatory figures: Catherine Livingstone as chairman, and David Thodey, a Telstra insider, as chief executive.

The saga of hostility began under the previous Australian government, which refused Telstra's requests to change the rules requiring the firm to share any future high-speed network with rivals at what it regarded as unreasonably low rates. Telstra hoped the new government of Kevin Rudd, elected in 2007, would be more amenable. The firm expected to be the main beneficiary of Mr Rudd's election pledge to create a national broadband network serving 98% of the population. But when the project was put out to tender last year, Telstra treated the process with contempt, submitting a flimsy, 12-page press release rather than a detailed, formal proposal. It was a terrible miscalculation: rather than bow to a hubristic company, the government banished it from the tender process.

Then in April Mr Rudd dropped a second bombshell by announcing that none of the bids, including that from Telstra's main rival, SingTel Optus, was up to scratch. Instead, the government said it would build a high-speed national network itself, at a cost of A$43 billion ($30 billion). The new network would use the latest "fibre to the home" technology, rendering Telstra's existing infrastructure of copper wires obsolete within five to ten years. The firm faced a humbling defeat and a huge new competitor: the government itself. As Mark McDonnell, a telecoms analyst with BBY, put it: "Telstra now faces an irrational investor driven by a political agenda and unconstrained by debt."

Yet the government does not have the expertise or experience to construct a national network—an enormous undertaking in such a vast, largely unpopulated country. Newspaper advertisements have recently appeared seeking "suitably qualified consultants". Though Mr Rudd has predicted that the network could be built within eight years, industry insiders think that is wildly optimistic. And if the new state-owned enterprise is to get a return on the huge investment required, broadband charges for consumers will have to rise.

Reuters



Can anyone here build networks?

So it may be in the mutual interest of the government and Telstra to make peace. One possibility is that Telstra will agree to the "functional separation" of its retail and wholesale business, replicating the deal struck in 2005 in Britain between BT and its regulator, Ofcom. This would promote competition, which has always been the Australian regulator's chief aim, but would avoid a messy break-up of Telstra, which could then participate in the construction of the new network. Another option is the forced break-up of Telstra, but with the company taking a stake of up to 49% in the new network. .

Paul Fletcher, a former Optus employee who has written a history of Australia's broadband battles, reckons that even if Telstra manages to come to terms with the government and participate in the construction of the new network, its problems are far from over. "Expectations are so high for the kind of national

broadband network that Kevin Rudd envisages that it may be difficult for Telstra to participate in a way that generates a commercial payback," he warns. That, however, is a problem for another day. The immediate priority for Telstra's new bosses is to build bridges, not networks.

Winners in Japan's recession

Gloom and boom

May 14th 2009 | TOKYO
From The Economist print edition

Despite the downturn, some Japanese companies are doing well

IT IS mayhem at the Tokyo Stock Exchange—not on the old trading floor, but a few floors above, where company officers and couriers jostle in the hallways and stand in queues to hand over annual results. May is corporate-earnings season in Japan—434 public firms are due to submit their results on May 15th alone. And this year the red ink is flowing.

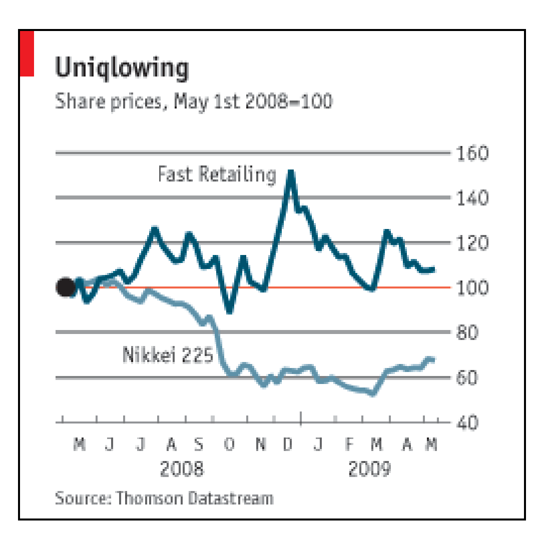
Toyota reported its first annual loss in 71 years, of ¥437 billion ($4.3 billion), reversing a record net profit of ¥1.71 trillion a year earlier. Hitachi suffered a ¥787 billion loss. Toshiba lost ¥343 billion and wants to raise ¥500 billion in fresh capital. Around 30% of Japan's 3,820 public companies are expected to post losses for 2008, according to Nikkei, a financial-news service. So dire is the situation that the Diet, Japan's parliament, passed legislation in April authorising the government to help bail out struggling companies. Pioneer, an electronics firm, and Elpida, a chipmaker, are said to be angling for ¥80 billion between them.

Yet it is not all gloom. Some Japanese firms are booming. One reason is that, as elsewhere, consumers are moving downmarket. Toyo Suisan Kaisha, a maker of instant noodles, has seen sales shoot up as customers trade down, as has Nitori, a maker of stylish but inexpensive furniture. Sales at convenience stores exceeded those at department stores for the first time in 2008, signalling a shift from chic to cheap.

Another reason for some companies' strong performance is specific to Japan, however. In more competitive markets, companies tend to innovate in good times and bad, explains Yuko Kawamoto of Waseda University, but in Japan it often takes a downturn to get companies and consumers to try new things. During Japan's "lost decade" in the 1990s some companies flourished by introducing high-quality products at low prices.

Two retailers that came of age during the lost decade are doing particularly well this time around: Uniqlo and Muji. Fast Retailing, the parent of Uniqlo, which sells casual clothing, saw same-store sales increase by 19% in April compared with a year earlier, the sixth consecutive monthly increase. Ryohin Keikaku, the parent of Muji, which sells everything from plastic bottles to prefabricated houses, expects sales to increase this year by a modest 3%.

Muji, short for Mujirushi Ryohin, literally means "no-brand quality goods." In brand-obsessed Japan, this was quite a departure. It began in the 1980s as a generic brand for Seiyu, a supermarket chain, and soon outgrew that role. With a reputation for minimalist design at reasonable prices, it operates around 350 shops in Japan, plus 100 overseas that account for 10% of revenue. It plans to expand the number of foreign stores over the next two years.



Likewise, Uniqlo started in the 1980s (as Unique Clothing Warehouse) but came to the fore during the lost decade. At the time clothing stores in Japan were either very expensive or very poor quality—there was very little in between. The company made two innovations. It focused on basic, unisex clothing—T-shirts, jeans, sweaters and so forth—that were stylish but did not follow fashion trends closely. It also made most of its products inexpensively in China, despite the fact that the Japanese usually prefer domestically made goods.

Tadashi Yanai, Uniqlo's founder and boss, wants to make his firm the world's largest clothing retailer. With sales last year of ¥586 billion, healthy profits and 770 stores in Japan and 70 overseas, his audacious aim is not absurd. This year *Forbes* named Mr Yanai Japan's richest person, with a worth of $6.1 billion. Before


the economic crisis is over, he may be richer yet.

Call the carabiniere

May 14th 2009
From The Economist print edition

Vittorio Colao has an ambitious plan to boost Vodafone's fortunes—and rescue the media industry

Photoshot



STRAIGHT is not always the best way up. Vittorio Colao, now the boss of Vodafone, is a prime example. In 2004 he left the world's largest mobile operator by revenues to run a company in an entirely different business: RCS MediaGroup, an Italian media conglomerate. He returned to Vodafone only two years later after a row with RCS's main shareholders, having gained some valuable insights. One is that telecoms and media firms are culturally very different—knocking on the head the idea that Vodafone ought to become a content provider. In addition the newspaper business showed him that rivals can share important infrastructure, such as distribution. "After all, they compete on their editorial quality," says Mr Colao, "not in driving trucks around."

That may help explain the thinking behind the ambitious project Vodafone announced on May 12th. It is a bold attempt to rally some of the industry's biggest operators to build a joint global platform through which software companies and content providers can sell things to mobile subscribers. If it is a success—admittedly, a big if—it will help address two of the criticisms levelled at Vodafone: that it is too big for its own good, and that mobile operators are destined to end up as "dumb pipes", mere utilities that transport data to and from handsets.

When Mr Colao was appointed as Vodafone's boss a year ago, he was not expected to come up with grand plans. Vodafone was no longer the global collection of wireless baronies that Sir Christopher Gent, the firm's swashbuckling boss, had put together in the 1990s through a series of daring acquisitions. But Sir Christopher's more down-to-earth successor, Arun Sarin, did not quite manage to make the pieces fit together. Vodafone's subsidiaries have yet to gain much from their parent's huge size, says Robin Bienenstock, an analyst at Bernstein Research. Mr Colao seemed to be just the man to fix this. In the 1990s while working at McKinsey, a consultancy, this reserve officer in the Italian Carabinieri and graduate of Harvard Business School had helped set up Omnitel Pronto, an Italian mobile operator, and later became its boss. In 2000 it became part of Vodafone and is still one of its most profitable units, thanks in part to his early work.

Just cutting costs and improving efficiency, however, is not enough in today's mobile-phone industry (though Vodafone's annual results on May 19th are expected to show that Mr Colao is rather good at it). The market for its main product, mobile telephony, is rapidly maturing in many rich countries. This prompted Mr Sarin to take control of several operators in developing countries that still boast rapid growth. Beyond that, operators have set out in search of new frontiers. One is mobile-data services, a market that is finally taking off after years of hype.

The problem for Vodafone and other operators is that they are trying to catch up. They have long offered such services, but steered users towards “walled gardens” of pre-approved content from which they could take a cut. This stifled the market and left an opening for other firms to create mobile-data platforms of their own. Apple led the way with its elegant iPhone and its “App Store” that gives users easy access to thousands of applications, and lets software developers charge for them. This inspired similar app-store platforms from other technology giants, including Google, Nokia, Microsoft and RIM, the maker of the BlackBerry.

Yet it is this variety that will allow Vodafone back into the game, argues Mr Colao. To make his point he enthusiastically presents visitors to his office at the firm’s headquarters in Newbury, an hour’s drive west of London, with two charts. The first, titled “Today: Complexity”, shows many boxes linked by arrows. A software firm must write several versions of its applications for different platforms, for example, and the owner of a particular handset is usually restricted to a particular platform. Mr Colao’s other chart, titled “Tomorrow: One relationship”, is centred on a big, red box labelled “Vodafone Services”. This is an über-platform that would allow programmers to write an application which could then run on other platforms, and would also provide essential sub-services, such as determining a user’s location and, most importantly, charging for downloads. Mr Colao promises not to be “too greedy”: Vodafone intends to pass on 70% of revenues to developers, the same share as Apple does.

One platform to rule them all

The idea of enabling a single piece of software to run on lots of devices has been tried before, but has never really succeeded. Software firms may feel more at home working with partners in the computer industry: mobile operators are widely seen as lumbering giants, if not greedy predators. And consumers may prefer handset, platform and software to come in a tightly integrated package, as with the iPhone. Most importantly, rival platform-owners are unlikely to co-operate, and might even scupper the project by introducing deliberate incompatibilities.

Still, Vodafone has one thing in its favour: size. It has more than 290m subscribers worldwide, all of whom are potential customers for software firms and content providers. And Mr Colao’s scheme is also backed by China Mobile, the world’s largest operator by subscriber numbers; Softbank, a Japanese conglomerate; and America’s Verizon Wireless, in which Vodafone has a 45% stake. If they realise their plans to launch their own app stores based on the new platform, the potential market will be more than 1 billion subscribers and span the entire globe.

Success is by no means guaranteed, but Mr Colao is not known for giving up easily. Indeed, it was his single-mindedness that got him into trouble at RCS. And if his plan takes off, he says, it could help save media, which he says is still his “second love”. Vodafone’s scheme would give publishers a way to charge small sums, or micropayments, for content—and put right “the big mistake they have made on the internet: giving their content away for free.” Will the industry, and consumers, play along?

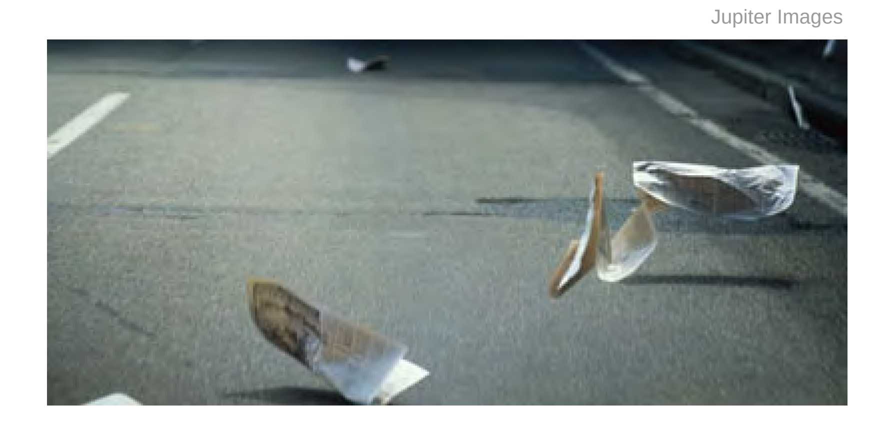
The news business

Tossed by a gale

May 14th 2009
From The Economist print edition

It isn't just newspapers: much of the established news industry is being blown away. Yet news is thriving

Jupiter Images



PERHAPS the surest sign that newspapers are doomed is that politicians, so often their targets, are beginning to feel sorry for them. On May 9th Barack Obama ended an otherwise comic speech with an earnest defence of an embattled business. House and Senate committees have held hearings in the past month. John Kerry, the junior senator from Massachusetts, called the newspaper "an endangered species".

Indeed it is. According to the American Society of News Editors, employment in the country's newsrooms has fallen by 15% in the past two years. Paul Zwillenberg of OC&C, a firm of consultants, reckons that almost 70 British local newspapers have shut since the beginning of 2008. The *Independent* and the *London Evening Standard* depend on the largesse of foreign investors. The strain is not confined to English-speaking countries: French newspapers have avoided the same fate only by securing an increase in their already hefty government subsidies.

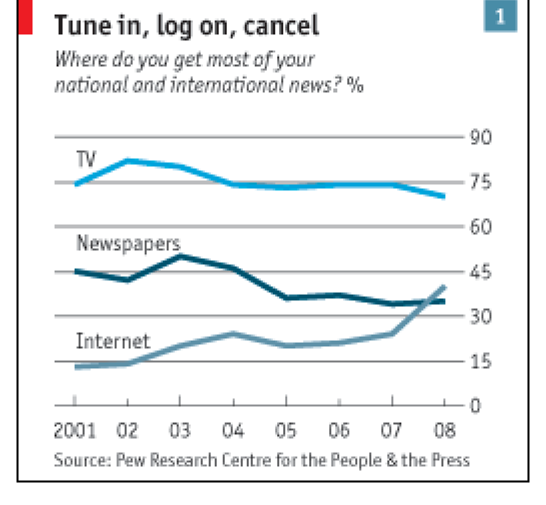
Broadcast television news is struggling too. Audiences have split and eroded: the share of Americans who watch the early evening news on the old "big three" broadcast networks (ABC, CBS and NBC) has fallen from about 30% in the early 1990s to about 16%. Local-news outfits are ailing as car dealers and shops trim their advertising. ITV, Britain's biggest commercial broadcaster, is pleading to be excused from its obligation to produce local news.

All this has provoked much hand-wringing. Yet the plight of the news business does not presage the end of news. As large branches of the industry wither, new shoots are rising. The result is a business that is smaller and less profitable, but also more efficient and innovative.

The clearest picture of how news consumption is changing comes from surveys by the Pew Research Centre. Since 1994 the share of Americans saying they had listened to a radio news broadcast the previous day has fallen from 47% to 35%. The share reading a newspaper has dropped from 58% to 34%. Meanwhile cable and internet audiences have grown. In 2008, for the first time, more people said they got their national and international news from the internet than from newspapers (see chart 1).

Deeper but not broader

It is not only a matter of people switching from one medium to another. Nearly everybody who obtains news from the internet also commonly watches it on television or reads a newspaper. Only 5% of Americans regularly get their news from the internet alone. Technology has enabled well-informed people to become even better informed but has not broadened the audience for news. The Pew Centre's most alarming finding, for anybody who works in the trade, is that the share of 18- to 24-year-olds who got no news at all the previous day has risen from 25% to 34% in the past ten years.



Those who do seek news obtain it in a different way. Rather than plodding through a morning paper and an evening broadcast, they increasingly seek the kind of information they want, when they want. Few pay. Robert Thomson, editor-in-chief of the *Wall Street Journal*, says many have come to view online news as "an all-you-can-eat buffet for which you pay a cable company the only charge."

The main victim of this trend is not so much the newspaper (although it is certainly declining) as the conventional news package. Open almost any leading metropolitan newspaper, or look at its website, and you will find the same things. There will be a mixture of local, national, international, business and sports news. There will be weather forecasts. There will be display and classified advertisements. There will be leaders, letters from readers, and probably a crossword.

This package, which was emulated first by broadcasters and then by internet pioneers such as AOL.com and MSN.com, works rather like an old-fashioned department store. It provides a fair selection of useful information of dependable quality in a single place. And the fate of the news package is similar to that of the department store. Some customers have been lured away by discount chains; others have been drawn to boutiques.

The Wal-Marts of the news world are online portals like Yahoo! and Google News, which collect tens of thousands of stories. Some are licensed from wire services like Reuters and the Associated Press. But most consist simply of a headline, a sentence and a link to a newspaper or television website where the full story can be read. The aggregators make money by funnelling readers past advertisements, which may be tailored to their presumed interests. They are cheap to run: Google News does not even employ an editor.

Although they are convenient, these news warehouses can feel impersonal. So another kind of aggregator has emerged, which offers a selection of news and commentary. Some are eclectic, like the *Daily Beast* and the *Drudge Report*—the grandfather of the boutique aggregators. Others are more specific, like *Perlentaucher*, a German cultural website. The most successful of the lot, and the template for many newly unemployed journalists who have tried to launch websites of their own, is the *Huffington Post*.

HuffPo, as it is broadly known, employs just four reporters among a total staff of about 60. Much of its news is second-hand. But it boasts an unpaid army of some 3,000 mostly left-wing bloggers. The website feels like a cross between a university common room and a Beverly Hills restaurant (your attitude to *HuffPo* will depend largely on whether you find this prospect appealing). Arianna Huffington, who runs it, calls it a "community around news". It now has 4.2m unique monthly visitors, according to comScore, an internet market-research company—almost twice as many as the *New York Post*.

Old-fashioned news folk increasingly complain that aggregators are "parasites" that profit from their work. They are, in a sense; but parasites can be useful. As the quality of journalism becomes more erratic, the job of sifting stories is increasingly vital. And aggregators drive readers, hence advertising, to original-news websites. Hitwise, another market-research firm, estimates that in March 22% of referrals to news sites came from search engines like Google, whereas 21% came from other news sites. "Reporters send us their stories all the time," notes Tina Brown, a magazine veteran who runs the *Daily Beast*.

The rise of the aggregators reveals an uncomfortable fact about the news business. The standard system of reporting, in which a journalist files a story that is broadcast or printed once and then put on a single proprietary website, is inefficient. The marginal cost of distributing the story more widely is close to nil, but the marginal benefit can be considerable. Interest in a story about Iraq in, say, the *Los Angeles*

Times extends far beyond that city. Before the aggregators appeared, a reader in Seville or even San Francisco probably would not have known it existed.

The inherent benefit of spreading stories around helps explain why some established news outfits are coming to resemble aggregators. The Associated Press has a popular iPhone application which combines national stories with local ones from 1,100 partner news outlets. News Corporation set up a website, *Fox Nation*, which mixes news stories with right-wing commentary. It is intended to become a conservative *Huffington Post*. Indeed, one of the great successes in both British and American news publishing is the *Week*, in effect an aggregator that is printed on paper.

With their stories roaming widely, English-language news outlets in particular are taking on broader identities. The *Guardian*'s website, visited by twice as many people outside Britain as inside, aims to become the international voice of liberal opinion. The *Daily Mail* has built a reputation for celebrity news. New contests are being joined. The BBC, which has set up a wire service and sells advertisements on its foreign websites, now competes with the Associated Press, which has moved beyond the business of supplying stories to American newspapers.

Up go the walls

General news is likely to remain free on the internet. The crush of similar stories is too great, the temptation of piracy is too strong and the aggregators are too good at sniffing out decent free reports. Yet it has become clear that online advertising alone cannot support good original journalism.

Until recently many print news executives believed that advertising revenues would follow their readers from print to the web. Between 2004 and 2007 online advertising revenues doubled from $1.5 billion to $3.2 billion, according to the Newspaper Association of America. But in the second quarter of 2008 they began to fall, just as the loss of print and classified advertisements accelerated (see chart 2). Worryingly, this cannot be blamed entirely on the recession. Online advertising money has moved to search—ie, Google—and excess supply has depressed prices of display advertisements. As a result, executives are looking hungrily at the few online outfits that dare ask readers for money.

One is the *Financial Times* (part-owner of *The Economist*) which demands registration of anybody wishing to view more than three articles per month and payment from anybody wanting to see more than ten. About 1m people are registered, of whom 109,000 pay. By going easy on casual readers, the *Financial Times* keeps a foot in what John Ridding, the company's chief executive, calls the "giant wave machines" of the internet, such as Google and Yahoo!, which drive traffic to the site. Registered readers are served targeted advertisements, which are more lucrative. It is an attempt to fuse a subscription model with one supported by advertising.

The *Wall Street Journal* takes a shrewd route to a similar destination. Rather than charging certain types of user, it charges for certain types of news. Earlier this week, it offered for nothing a story about swine flu, a review of the new "Star Trek" film and a report on looming cuts at car dealerships. It charged for pieces on Cigna Corporation's pension plan, Lockheed Martin's quarterly lobbying expenditures and a lawsuit against a bottling company which alleges that a board meeting was held improperly. In short, the fun articles are free. The dry, obscure stuff costs money.

The thinking is that broadly appealing articles draw readers to the website, where they can be tempted by advertisers and by the *Journal*'s more selective wares. Most people do not care about pensions in a Philadelphia health-insurance company. But those who are interested in such information are very interested, so much so that they will probably pay a monthly subscription for it. Just over 1m do—even though the specialised articles can be read for nothing via Google. And those who cross the main pay wall may be persuaded to purchase more premium content. The paper is also exploring a "micro-payments" model for individual articles.

Financial news is not the only kind for which people appear prepared to pay. ESPN, a cable sports

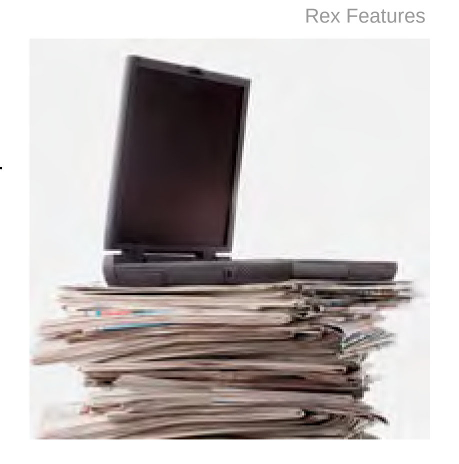
channel, has erected several pay walls on its website. They protect information that only the most rabid fan would want to know, adhering to the *Wall Street Journal*'s dictum that people's willingness to pay for a story is inversely correlated with the size of its potential audience. The number of profitable news niches may grow as rivals close bureaus or go out of business altogether.

Newspapers and magazines are more likely to be rescued by a careful combination of free and paid-for content than by new technology. Portable news readers such as the Kindle DX, which some have hailed as potential saviours, will help only to the extent that they lure readers from the web, where news is mostly free. At the moment they seem to be doing something else. Ken Doctor of Outsell, a research firm, reckons that the Kindle appeals to baby-boomers who would otherwise read a paper magazine or newspaper. The young prefer their iPhones and their aggregators. Indeed, the top four magazines on Kindle, according to Amazon's website, are the *New Yorker*, *Newsweek*, *Time* and *Reader's Digest*. Not much of a youth market there.

King comment

On cable television, a different kind of niche product is cleaning up. The right-wing Fox News Channel has become by far the most popular specialist provider of news. This is not surprising. The channel's newscasts and opinion shows are well-produced, and the crumbling of the Republican Party has left conservatives seeking a voice. Rather more surprising is that the left-wing MSNBC now draws more prime-time viewers aged 25 to 54 than the much more established CNN.

Rex Features



Fox and MSNBC provide a mixture of news, interviews and occasionally furious commentary. Phil Griffin, the chief executive of MSNBC, calls it "news-plus". The aim is to complement and give meaning to the mass of disconnected information that viewers pick up during the day. Viewers know what they are getting; indeed, they rate cable shows as more reliable than newspapers. Against the common charge of partisanship, Mr Griffin offers what could be the slogan of the cable news industry: "We're not trying to be all things to all people."

Hot talk may be popular at the moment because Americans are politically polarised. The calmer CNN won the battle for cable viewers on election night and may well do so again in 2012. Yet, as in so much of the news business, a return to normal is improbable. The market for news is likely to remain unstable, favouring different providers at different points in political, economic and even sporting cycles.

Take *Real Clear Politics*, an American political website, which aggregates news, commentary and opinion polls. It became essential reading during last year's presidential race. At its peak, shortly before the election, it attracted 1.4m unique visitors a month, according to comScore. Since then its popularity has plunged by 75%. Rivals like *Fivethirtyeight.com* and *Talking Points Memo* have lost many readers too. For newspapers, magazines and television programmes, with their high fixed costs, such fluctuations would be ruinous.

Not so long ago, news was a highly profitable business. Regional newspapers cultivated cosy monopolies and routinely enjoyed annual profit margins of more than 20%. In America local television stations sometimes had margins approaching 50%. Yet news does not always have to be profitable in order to survive.

Even in their diminished state, large newspapers attract rich men who seek political or business clout, or who believe that there is money to be made after all. Tony O'Reilly, who ran Independent News & Media until this year, used to describe the *Independent* newspaper as a calling card. He tolerated its losses, although the company's shareholders have been less patient. Rupert Murdoch's fondness for printer's ink has sometimes baffled Wall Street analysts. Still, last month David Geffen, a media mogul, reportedly tried to buy a stake in the parent company of the *New York Times*.

Less glamorous outfits can also attract benefactors. San Diego has a small, scrappy news website that was paid for at first largely by a local businessman. The *Voice of San Diego* concentrates on nitty-gritty issues such as water, crime and health care—the sort of stories that local newspapers used to cover extensively. Indeed, America long ago proved that radio news can be supplied by non-profit organisations. In the absence of profitable alternatives, it may be that expensive, worthy journalism on

subjects like the war in Iraq will increasingly be supported by charity.

The spread of digital cameras has also enabled ordinary people to file pictures and news reports directly. They are encouraged in this by established news outlets like CNN, which have come to view citizen journalists as a source of both content and page views. Citizens have proved excellent reporters of dramatic, obvious news, such as terrorist attacks and sightings of Britney Spears. Leonard Brody, the head of *NowPublic*, a large Canadian news-gatherer, believes that amateurs will eventually liberate journalists from the tedious business of reporting, leaving them free to concentrate on analysis. He means it kindly.

Just now journalists have less competition from crowds than from governments. In Britain local authorities have created newsletters that carry advertising. The annual budget for the websites of the (state-owned) BBC was recently raised to £145m ($220m). According to Mr Zwillenberg, the total online spending of the country's national newspapers is only £100m.

America's president has proved an especially prolific citizen journalist. People who let Barack Obama's campaign team have their e-mail address last year still receive the occasional missive. The White House posts videos on YouTube that are often more polished than those produced by the news networks. In case the intention to bypass the news filter were not clear, during his second press conference on March 24th the president did not take a single question from a leading daily newspaper. Clearly, he knows where the future lies.

The decline of once-great newspapers and news programmes is not without cost. It means the end of a certain kind of civic sensibility that was built on broad agreement about what is important and what is not. But it was once difficult to imagine city centres without the unifying presence of department stores. Many of them went, yet people carried on shopping.

Asian economies

Crouching tigers, stirring dragons

May 14th 2009 | HONG KONG
From The Economist print edition

The Asian economies are likely to be the first to pull out of the global recession

Illustration by S. Kambayashi



ASIA'S tiger economies have suffered some of the sharpest declines in output during the global recession, and some fear that, because of their dependence on exports, they will not see a sustained recovery until demand rebounds in America and Europe. However, their doughty resilience should not be underestimated. They came roaring back unexpectedly fast after the Asian crisis of the late 1990s. They could surprise again.

Across the region as a whole, the slump has been as bad as it was in 1998. China and India have continued to grow, but in the rest of emerging Asia GDP plunged by an annualised 15% in the fourth quarter of 2008. Only three economies have published first-quarter figures. China's GDP growth accelerated to an annualised rate of over 6%, up from around 1% in the previous quarter. South Korea's GDP expanded by 0.2%, after plunging 19% in the previous three months. But Singapore's GDP fell by 20%, even more than in the fourth quarter.

More timely export figures suggest that the worst may be over. Although the headline numbers show that South Korea's exports fell by 19% in the year to April, they rose by a seasonally adjusted annualised rate of 53% in the three months to April compared with the previous three months, Goldman Sachs estimates; Taiwan's grew by an annualised 29% over the same period. China's exports over the past few months have managed only to stabilise, but its industrial production jumped by an annualised 25% in the past three months.

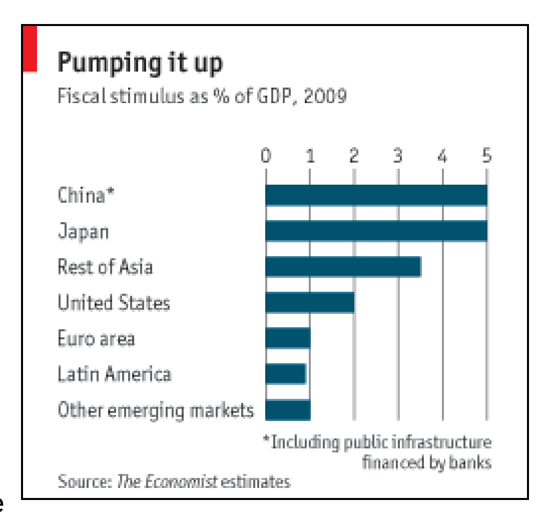
Economists are revising up their forecasts for China's GDP growth this year: 8% may now be possible even if American consumers remain frugal. There is a myth that China's growth depends on American consumers. In fact, if measured on a value-added basis (to exclude the cost of imported components), China's exports to America account for less than 5% of its GDP.

There is more argument, however, over the smaller, more export-driven economies, such as Hong Kong, South Korea, Singapore and Taiwan. Robert Subbaraman, an economist at Nomura, offers several reasons why they are likely to remain sluggish for the time being. The recent rise in exports and production, he argues, largely reflects the fact that firms are no longer running down stocks. This will provide only a temporary boost unless global demand picks up. Firms' spare capacity also means that investment will continue to fall, while rising unemployment threatens to dent consumer spending. Nor is China's stronger

growth likely to save the region. Over 60% of China's imports come from the rest of Asia, but about half of these are components that are assembled in China and then sold to the rich world.

In its latest economic outlook on Asia, the IMF forecast that the region excluding China and India would grow by only 1.6% in 2010, largely because it expects the American economy to be flat. However, Peter Redward of Barclays Capital argues that Asia can recover earlier and more strongly than elsewhere. In 2010, he reckons, the smaller Asian economies could grow by almost 4%, or close to 7% once China and India are added in.

One reason for his optimism is his explanation for why the Asian economies were hit so hard in the first place. Asians are often blamed for saving too much and spending too little, but Mr Redward argues that the main reason for their plight was that manufacturing accounts for a much larger share of GDP than elsewhere. Industries such as cars, electronic goods and capital machinery are highly cyclical. In rich and emerging economies, GDP fell furthest last year in countries with the largest share of manufacturing. This, in turn, could imply a sharp recovery.



A second reason for expecting a stronger bounce is that fiscal stimulus in Asia is bigger than in other regions (see chart). China, Japan, Singapore, South Korea, Taiwan and Malaysia have all announced fiscal packages of more than 4% of GDP for 2009, twice as large as America's stimulus this year. The pump-priming should also work better in Asia than in America or Europe, because modest corporate and household debts mean that tax cuts or cash handouts are more likely to be spent than saved. Banks, moreover, are in much better shape and so have more freedom to support an increase in domestic spending.

As the world's largest importers of oil and other commodities, the tiger economies have also benefited hugely from the fall in prices over the past year. This has acted like a tax cut, boosting real incomes and profits. Asia has enjoyed a gain from cheaper oil of almost 3% of GDP this year. Add in lower prices for food and raw materials and the total gain could match the governments' stimulus (though the danger remains of a renewed spike in oil prices).

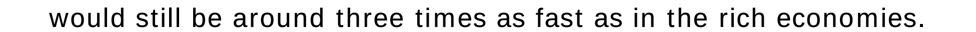
Pessimists maintain that Asia has always been pulled out from previous recessions, such as the 1998 financial crisis, by strong exports to the West. However, a recent analysis by Frederic Neumann and Robert Prior-Wandesforde, both of HSBC, finds that, contrary to received wisdom, Asia's recovery from its 1998 slump was led not by exports, but by consumer spending. Exports to the West did not surge until 2000. The region's current-account surplus actually shrank between 1998 and 2001.

Thanks to a large fiscal stimulus and the healthier state of private-sector balance-sheets in most economies, domestic spending (consumption and investment) should revive earlier in emerging Asia than elsewhere, rising by perhaps 7% next year, up from 4-5% this year. America's domestic demand is expected to remain weak in 2010 after falling sharply this year. Indeed, add in Japan and total Asian domestic spending (at market exchange rates) looks set to overtake America's next year.

But what of emerging Asia's longer-term prospects? Much of the increase in Asian domestic demand this year and next will come from government investment. Unlike rich countries, emerging Asia has room to keep investing in infrastructure for several years but governments need to encourage more consumption to fill the gap after the infrastructure projects are completed. Asian households' low rate of consumption and borrowing means that they have huge scope to spend more. Better social safety-nets might encourage Asians to save less. Governments also need to lift households' share of national income by reducing their bias towards capital-intensive manufacturing and encouraging more labour-intensive growth.

Ultimately, relatively robust expansion in domestic spending should help most Asian economies to keep growing faster than the rest of the world. But the tigers are unlikely to return to their heady growth rates of recent years. Nor would that be desirable given the impact on inflation and the environment.

Suppose that net exports contribute nothing to growth, and that domestic demand grows at roughly the same pace as it has in the past five years. Then emerging Asia could see annual growth of almost 7% over the next five years (around 8% in China, a more modest 5% in the smaller economies). That might sound disappointing for economies that enjoyed average growth of 9% in the three years to 2007. But it


would still be around three times as fast as in the rich economies.

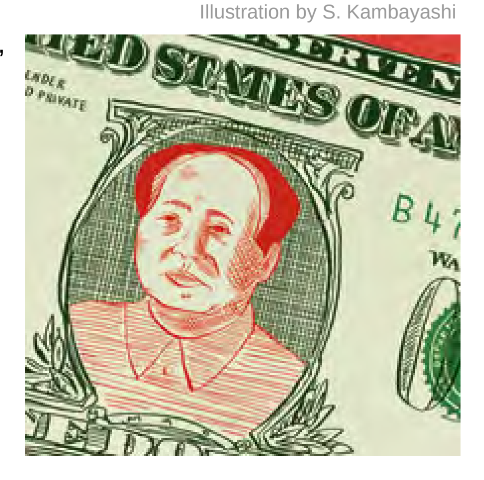
Buttonwood

Birth pains

May 14th 2009
From The Economist print edition

A new global system is coming into existence

Illustration by S. Kambayashi



ALL monetary and economic systems are a struggle between borrowers, who favour inflation, and creditors, who are determined to maintain the purchasing power of the currency. In a democracy, this is a very fluid battle. The creditors have the money and therefore the ear of the political elite; the borrowers tend to have the votes.

Creditors have periodically imposed monetary anchors in an attempt to defeat the borrowers' lobby. These anchors are devised in prosperous times but run into difficulty during recessions. The gold standard failed to outlast the Depression. For nations with a shortage of gold, the "right" thing to do was to raise interest rates in an attempt to lure gold back; the austerity this imposed on the rest of the economy was politically unacceptable.

The Bretton Woods era replaced a gold standard with a dollar standard (albeit with the American currency theoretically linked to bullion). The system worked well for more than two decades, helped by the post-war economic boom, particularly in Germany and Japan which began the period with undervalued exchange rates. It broke down because America refused to pay the domestic price for bearing the system's weight.

When Bretton Woods failed, it was not immediately obvious what would replace it. European nations, in particular, maintained a hankering for fixed exchange rates. But floating rates eventually prevailed, particularly for the major currencies of the dollar, yen and D-mark.

The problem for creditors was that the floating-rate system was based on fiat (paper) money. What would keep the inflationary instincts of governments in check? The answer took a couple of decades (and recessions) to hammer out.

Once it was accepted that the markets could set exchange rates, there was no real need for capital controls. And once capital could flow freely, ill-disciplined governments could be punished by higher bond yields. Politicians accordingly tried to reassure the markets by giving greater power to central banks, some of which set explicit inflation targets.

The post-Bretton Woods system worked well, engendering the long period of low inflation and steady growth known as the Great Moderation. But one of the reasons for its apparent success—the growth of India and China—may have sparked its demise. The addition of these two great nations to the international financial system was a supply shock that put downward pressure on inflation rates.

As Stephen King, an economist at HSBC, has pointed out, the result might have been a benign deflation that boosted Western living standards. But central banks struggled to avoid a deflationary outcome; the result was a loose monetary policy that encouraged asset bubbles. Those bubbles lasted longer than expected because the flood of savings from developing markets held down the risk-free rate.

Now it seems to be recognised that inflation targeting is not enough. Given the explicit government guarantee behind the banking system, central banks need to monitor both financial stability and asset prices. At the same time, some central banks have adopted (via quantitative easing) a policy of creating money to boost markets that also has the convenient side-effect of funding budget deficits. That is just what opponents of fiat money feared would happen in the long run.

The same old dilemma will eventually occur. Having spent a fortune bailing out their banks, Western governments will have to pay a price in terms of higher taxes to meet the interest on that debt. In the

case of countries (like Britain and America) that have trade as well as budget deficits, those higher taxes will be needed to meet the claims of foreign creditors. Given the political implications of such austerity, the temptation will be to default by stealth, by letting their currencies depreciate. Investors are increasingly alive to this danger; ten-year Treasury bond yields are around a percentage point higher than they were at the start of the year.

Creditor nations tend to set the rules and the new global monetary system will be unable to operate without the approval of China, a creditor country that has capital controls and a managed currency. It has been assumed that China will have to move towards the Western model. But why not the other way round? Western countries adopted free capital markets, as the British adopted free trade in the 19th century, because it suited them. Will China now be able to call the shots? Uncomfortable as it might be for the West, the next monetary order is more likely to be made in Beijing than in New Hampshire.

Economist.com/blogs/Buttonwood



FINANCE & ECONOMICS

Stress tests

Hospital pass

May 14th 2009
From The Economist print edition

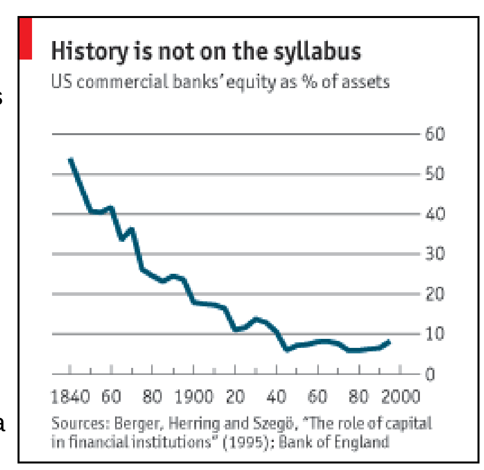
America's stress tests were too easy

ARE America's banks: a) healthy, b) insolvent, or c) being kept alive by the government but delighted to pretend otherwise? After announcing the results of the stress tests of the 19 biggest lenders on May 7th, officials and bankers invited the world to tick answer a)—though c) looks far more plausible. Ben Bernanke, chairman of the Federal Reserve, said the public and investors should take "considerable comfort". Executives testified to how conservative (read absurdly pessimistic) the tests were and share prices reacted euphorically. For a moment it felt like everyone might start high-fiving and originating subprime mortgages again.

Since the results, six banks have together sold $19 billion of common stock, going some way to plugging the $75 billion overall capital gap that the tests identified. Further capital-raising is imminent. Bank of America has the biggest shortfall. It plans to sell shares worth $17 billion and on May 12th sold a $7.3 billion stake in China Construction Bank to mainly Chinese and Singaporean investors. Add in a couple more bumper quarters of earnings, the banks say, and the $75 billion gap will close. Only GMAC seems at risk of being nationalised. The former financing arm of General Motors is now partly owned by private-equity firms and is terribly thinly capitalised.

That any bank can sell equity is one big benefit of the stress test. By producing a credible estimate of losses over the next two years—$600 billion—officials have restored some confidence in the banks' word. Many observers believe the economic assumptions being used are a bit too optimistic (although the IMF has come up with a similar number for losses). But investors can now buy a bank's shares and be confident that its books are not being cooked flagrantly and that it is not about to be nationalised. The rally in recent months has helped, as has the commendably clear presentation of the test results.

It is the buffer needed to absorb the projected losses where the tests are lax. The precise definition of core capital used—"tier-one common"—allows banks to take advantage of the recent relaxation of accounting rules. And the tests state that the 19 banks' core capital be at least 4% of risk-weighted assets (this equates to 2.7% of their assets). This is below where the system was at the end of 2008 (5% of risk-weighted assets), below today's European levels (7%), below the IMF's suggested range (6-9%) and below the strongest banks globally (above 8%). By historical standards it is feeble (see chart).



Although banks do typically run down capital in a recession, it is clear that they still do not command enough market confidence to borrow at commercially attractive rates. Immediately after the stress-test results, Bank of America and Morgan Stanley issued bonds without state guarantees. If this was meant to be a show of bravado it fell flat; both paid an interest rate of four to five percentage points more than the government. On May 13th JPMorgan Chase, which passed the stress test and is judged America's safest bank by many, issued debt at a spread of about three percentage points, a little less than it paid in April.

In effect the stress tests asked American banks if they had more capital than losses. A better question is whether they have enough capital to stand on their own without a state guarantee. Any hopes that Europe might do better were dashed when its regulators promised to conduct similar tests, to keep the results secret and to avoid singling out individual lenders. That points to a Japanese-style future for Western banks, in which a thinly capitalised system staggers along, insisting on its rude health, while the state follows holding crutches an inch beneath its armpits. If that is the answer, then the stress tests were asking the wrong question.

Bank regulation

Dilute or die

May 14th 2009
From The Economist print edition

Using market signals to gauge a bank's health

AS THE tab for bank bail-outs rises, the notion that a firm can be "too big to fail" has become almost too much to stomach. What is needed is a regulatory regime that disciplines banks without forcing them to the wall in such a way that their demise wrecks the payments system. One way is to make banks hold so much equity, and so little debt, that even huge losses would not lead to insolvency. Debt has its advantages, however. For instance, it can be cheaper than equity finance, thanks to tax breaks.

In new research, Oliver Hart, of Harvard University, and Luigi Zingales, of the University of Chicago, argue that the mix of debt and equity should fluctuate according to the risk of bank failure. Banks should hold less capital in good times and reduce leverage when losses loom. This could be achieved in the absence of an all-wise regulator by using the cost of credit-default swaps (CDSs), which insure against default, as a guide to the right capital structure.

In their scheme, when a bank's CDS price stays above a certain threshold, the regulator forces managers to inject enough equity capital to cushion bondholders against losses. If the bank does not act swiftly to push the CDS price back down, the regulator seizes the assets, wipes out shareholders and sacks the management. The bank is recapitalised as a going concern and later sold. Creditors get some of the proceeds, but would not be made whole.

The appeal of this kind of capital regime is that regulators would be less prone to capture. The market does the monitoring job: CDS prices act as a check on excessively risky business strategies. But banks are opaque outfits and markets prone to panics, so CDS prices could easily be wrong. To counter the risk of a false alarm, the regulator would reserve the right to declare a bank solvent after an audit. That would give lobbyists an opening to sway the outcome, but the process would at least be transparent.

The idea's main strength is that it creates a trigger for action. Banks are forced to raise equity, and regulators to intervene quickly, before trouble spreads. A rule based on CDS prices would have forced earlier interventions in this crisis—though perhaps not early enough. For such a scheme to work, everyone needs to believe that banks would be allowed to fail. The trouble is, who would credit that now?

The poor

Smooth operators

May 14th 2009
From The Economist print edition

Even those with very little money have a sophisticated approach to finance

PAYING interest on your savings will strike most people as odd. Yet some poor people in the developing world do just that. In West Africa, for example, some people pay roving *susu* collectors a fee amounting to a -40% annual interest rate for looking after their deposits.

And the authors of a new book* about the financial lives of people who earn less than $2 a day find that this sort of "pay-to-save" model is by no means unique to Africa. They encounter a similar phenomenon in India, where a female deposit collector called Jyothi looks after small savings for people in the slums of Vijayawada, at an effective yearly interest rate of -30%.

Some of Jyothi's customers are among the 250 families in South Africa, India and Bangladesh whose financial transactions over a year were recorded to study how very poor people manage their resources. Given that these are so meagre, this might seem to be an unpromising line of inquiry. But as many of the subjects emphasised, controlling the flow of cash becomes all the more critical when income is not just low, but also unpredictable and irregular.

These features are what economists like to call "consumption smoothing"—spreading spending out in a way that ensures that what you eat one day is not determined by what you have earned that day or the day before. The subjects used a combination of loans and savings to ensure that their lives were not, literally, hostage to fortune. Hardly anyone lived utterly hand-to-mouth.

The research provides evidence of the sophistication with which poor people think about their finances. They are acutely aware, for example, of the importance of some psychological phenomena whose effects behavioural economists have only recently begun to explore. For instance, they purposefully seek out commitments to help ensure that they meet their saving goals. Many of the South African women in the study joined several monthly "savings clubs" in spite of having bank accounts. They found that the extra discipline the clubs provided was valuable in itself, because it compelled them to save no matter what.

Reuters



A load on his mind

Some went further. The mother of a Bangladeshi man who found himself unable to stick to his monthly saving goal found she could make him save more by taking out a loan from a microfinance company. The shared obligation of having to pay the regular loan instalments meant he abandoned his spendthrift ways.

The unbanked do not have access to such luxuries as standing orders, which richer people use to overcome the temptation to spend whatever they earn. And they are forced to pay for things that are free for most—which enables women like Jyothi to earn a crust by offering a safe store for small savings. But with some ingenuity, they use unorthodox financial instruments to create a more stable life than their erratic incomes would otherwise allow.

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*"Portfolios of the Poor", by Daryl Collins, Jonathan Morduch, Stuart Rutherford and Orlanda Ruthven.

Hedge funds

Gluttons for punishment?

May 14th 2009
From The Economist print edition

Investors in hedge funds remain unexpectedly enthusiastic

HEDGE-FUND managers are not forgiving types but their customers appear to be. Six months ago the industry looked as if it could be crushed. Although hedge funds were not the financial weapons of mass destruction that many had feared, they spectacularly failed to achieve the absolute returns that were supposed to justify their high fees. Clients flocked to redeem money, which exposed the mismatch between the illiquid assets some mangers invested in and their volatile funding. To prevent fire-sales, some funds ended up locking in investors against their wishes. And then came the Madoff scandal, which confirmed the suspicion that some funds of funds, which are supposed to funnel money to talented managers, were only marginally less useless than Bernard Madoff's auditor.

That, in short, is the charge sheet against the industry. Yet a recent survey of most of the world's big hedge-fund investors, by Goldman Sachs, suggests that clients remain surprisingly happy. Only 15% of their assets are subject to "gates" that stop them withdrawing money, suggesting there is little pent-up demand for further redemptions. Indeed, recent comments by several big managers indicate money is flowing back into their funds now. And, according to the survey, clients think funds of funds will continue to supply just over half of hedge-fund assets under management.

Nor does there appear to be much appetite to reform the structure of hedge funds. One mooted solution to the liquidity mismatch is to give each client a separate "managed account", rather than pooling them together in such a way that loyal investors are saddled with the most illiquid assets. Yet the survey suggests that few clients expect this idea to fly, at least this year.

Are clients forgiving to the point of naivety? Perhaps. But the reality is that, a couple of blow-ups aside, hedge funds have proved less risky than most other financial firms. Their main weakness has been performance and here clients are being a bit tougher. An overwhelming majority expect fees to fall, for hedge funds and funds of funds. They are willing to stick with an industry with a mediocre record—so long as charges are lower. Slowly but surely, hedge funds are becoming like the old-fashioned asset managers they once aimed to usurp.

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Damage assessment

May 14th 2009
From The Economist print edition

How much will the financial crisis hurt America's economic potential?

Illustration by Jac Depczyk



AMID the hubbub over a few less-bad-than-expected statistics, America's economic debate has turned to the nature of the recovery. Optimists expect a vigorous rebound as confidence returns, pent-up demand is unleashed and massive government stimulus takes effect. Most observers, including this newspaper, are bracing for a long slog, as debt-laden consumers rebuild their savings, output growth remains weak and unemployment continues to rise. There is, however, something that eventually will have a much bigger impact on Americans' prosperity than the slope of the recovery. That is the effect of the crisis on America's potential rate of growth itself.

An economy's long-term speed limit (its "trend" or "potential" rate of growth) is the pace at which GDP can expand without affecting unemployment and, hence, inflation. It is determined by growth in the supply of labour (the number of workers and how long they toil) along with the speed with which productivity improves. The pace of potential growth helps determine the sustainability of everything from public debt to the prices of shares.

Unfortunately, the outlook for America's potential growth rate was darkening long before the financial crisis hit. The IT-induced productivity revolution, which sent potential output soaring at the end of the 1990s, has waned. More important, America's labour supply is growing more slowly as the population ages, the share of women working has levelled off and that of students who work has fallen. Since 1991 the labour supply has risen at an average annual pace of 1.1%. Over the next decade the Congressional Budget Office expects a 0.6% annual increase.

According to Robert Gordon, a productivity guru at Northwestern University, America's trend rate of growth in 2008 was only 2.5%, the lowest rate in its history, and well below the 3-3.5% that many took for granted a few years ago. Without factoring in the financial crisis, Mr Gordon expects potential growth to fall to 2.35% over the coming years.

That alone is grim news. But has the Great Recession made things worse? In theory, it could do. Slumping investment may slow the pace of innovation. Soaring government debt could raise interest rates. Higher taxes, designed to reduce the debt, might dull incentives to work and invest. More regulation, in finance and beyond, could deter innovation. Workers' skills may atrophy as a result of joblessness. On the plus side, well-targeted government spending on, say, infrastructure or education could boost potential output,

while the huge wealth that Americans have lost may induce more of them to work for longer.

History sends mixed signals about how much these effects matter. Surprisingly, the 1930s bode well. Despite the deep slump in growth and investment, America's potential growth rate is reckoned to have risen smartly during the decade, as innovations from nylon to synthetic rubber proliferated, while business processes were fundamentally overhauled. Alexander Field, an economist at Santa Clara University, has called the 1930s the "most technologically progressive" decade of the 20th century.

In the modern era Sweden offers grounds for optimism. Its productivity growth accelerated after the early 1990s financial crash, in part because the government dealt swiftly with the banking mess. Japan, in contrast, saw productivity growth shrivel in the early 1990s. Several studies pin blame for that on Japan's unwillingness to tackle its banking mess. But the process was not irreversible; Adam Posen of the Peterson Institute has argued that by the late 1990s Japan's potential output had risen modestly, thanks to financial reform and broader deregulation. Nor is there much sign that Japan's gaping budget deficits have crowded out private investment. Yields on long-term Japanese bonds slumped from 7% in 1990 to 1% in 2003, and are still only 1.45%, even as gross public debt is heading for 200% of GDP.

Is this cause for optimism about America? Possibly not. Compared with the 1930s, America's workers are more specialised, which makes it harder to shift occupation; they are also more cushioned with social protection, which reduces the urgency to adapt. Workers are less flexible because the housing bust will prevent many from selling their houses to move to where the jobs are. JPMorgan estimates that America's natural rate of joblessness may have risen from 4.75% to closer to 6%.

Today's investment slump may have particularly pernicious effects on productivity because, unlike Japan's, it does not follow a capital-spending binge. During the recent bubble years, America's housing investment boomed, but corporate investment was laid low by the dotcom bust.

Debt burden

Most important, even if Americans become thriftier, soaring public debt may crowd out private investment more than in Japan, which, unlike America, is a creditor country. Already American bond yields are starting to rise. Academics differ about just how much bigger budget deficits and higher public debt affect interest rates, but most agree that they do. A 2004 study suggests that interest rates rise by 0.03% for every 1% increase in the debt/GDP ratio. That ratio is set to rise by 30 percentage points between 2008 and 2011, which implies a 1% higher risk-free interest rate, and commensurately lower private-sector investment. Even if higher private saving blunts the effect, some crowding out is eventually all too likely.

All of these effects can be mitigated by good policies, or exacerbated by bad ones. Sensible approaches to reducing America's long-term deficit, by tackling entitlement spending or reforming the tax code, would minimise the rise in long-term yields and might even boost potential growth. Misguided efforts to prop up declining industries or dictate lending decisions would add to the damage. America is heading for an era of slower growth. Just how much slower is still up for grabs.

Astronomy

Peek-a-boo

May 14th 2009
From The Economist print edition

Astronomers get some new toys to play with

AP



FEW scientists believe that the space shuttle has helped their profession. Mostly, it has been used to convey astronauts to a space station that has produced little worthwhile research and to launch satellites that might have been put into orbit more cheaply by old-fashioned, throwaway rockets. But it has done one thing to assist astronomers. It has allowed what is probably their most famous instrument to be repaired and upgraded. That instrument is the *Hubble* space telescope, which took the picture of the Carina nebula shown above, and has snapped more than half a million other images over the years. Now, as the shuttle programme draws to its close (the final launch will take place next year), *Hubble* is to be given its last makeover by the crew of *Atlantis*. On top of that, if the week has gone well, two other satellites intended to probe the universe's earliest days will have been launched.

The mission to *Hubble*, which began on May 11th and is planned to last 11 days, will install a wide-field camera that will let the telescope see galaxies previously beyond its reach. Using this, the eager coteries of astronomers who have access to the instrument will be able to observe young, hot stars that glow mainly in the ultraviolet part of the spectrum. They will also be able to see the first stars and galaxies that formed in the universe, which are now so old and distant that their light has been relegated to the infra-red part of the spectrum by the "red shift" caused by the universe's expansion. These wonders can be observed only from space, because ozone and water in the Earth's atmosphere absorb light at those wavelengths.

Atlantis's crew will, as well, add a "cosmic origins spectrograph" to the telescope, to parse light in a way that reveals which chemical elements it has been interacting with. This will allow astronomers to examine the evolution of galaxies, the formation of planets and the synthesis of chemical elements from the primeval hydrogen and helium that constituted the primitive universe. The spectrograph will also be used to investigate the structure and composition of matter concentrated in the "cosmic web"—long, narrow filaments of galaxies and intergalactic gas separated by huge voids. To do this, it will look at what happens to the light coming from faint, distant quasars as it passes through the web. Absorption of this light should reveal the composition and specific location in space of the constituents of the cosmic web, illuminating both the large-scale structure of the universe and progressive changes in the chemical composition of matter as time has gone by.

More prosaically, *Hubble* will receive new protective blankets, gyroscopes and batteries, a unit that transmits data to Earth will be replaced, and two existing instruments will be repaired. The upgrade should keep it running until 2014 when its successor, the *James Webb* space telescope, is supposed to be launched. Meanwhile, on May 14th, the European Space Agency should have added its own contribution to the study of the infant universe. It was due, as *The Economist* went to press, to launch two satellites the more familiar way, aboard a disposable rocket.

Peering into the cradle

One of these satellites, *Planck*, will look at the cosmic microwave background, a snapshot taken a mere 380,000 years after the Big Bang. That was the moment when matter started to coalesce and the universe became transparent. The radiation of the microwave background is mostly uniform, but small variations in its intensity show the origins of what went on to become galaxies, stars, planets and, in at least one instance, intelligent life. The first snapshot of the infant universe was made in 1992 and a second, more detailed, followed in 2003. Mapping the cosmic microwave background is hard because the Milky Way itself shines quite brightly at these wavelengths, making the background hard to discern. *Planck* is expected to generate as sharp an image as is physically possible, given the foreground glare.

Astronomers are hopeful that *Planck* will be able to identify how dark matter, a mysterious substance that makes up a quarter of the universe, forms larger structures that, by exerting a strong gravitational pull, determine the distribution of more familiar (but rarer) visible matter. They will examine temperature variations in the microwave background amounting to a few millionths of a degree, to see whether they can discern such features in it. Meanwhile, another team will be listening for the echoes of primordial gravitational waves—ripples in the fabric of space and time.

The second European satellite, *Herschel*, will scrutinise the universe at infra-red wavelengths. Stars and planets form within swirling clouds of dust and gas that visible light cannot penetrate, but which infra-red radiation can. *Herschel* will study the formation of galaxies and examine how they age. It will also peek at star-forming regions within galaxies.

When Edwin Hubble, the astronomer after whom the space telescope is named, looked at the skies in the 1920s using what was then the world's largest telescope, he found that there were galaxies outside the Milky Way, an observation that profoundly shocked his contemporaries. Max Planck founded quantum theory, and thus wrecked the Newtonian universe. And William Herschel discovered Uranus, the first planet unknown to the astrologers of old. If the new and refurbished instruments named after these scientific mould-breakers do as much in the next few years as their eponyms did, it will, indeed, be an exciting time for astronomy and physics.

Palaeolithic pornography

Unveiled

May 14th 2009
From The Economist print edition

Smut carved from a mammoth tusk

Nature



From photography to the internet, a characteristic sign that a new medium is going to succeed is that it is exploited by pornographers. And that, it seems, is not a recent phenomenon. A find reported in this week's *Nature* suggests that sculpture, too, brought the smut-makers in early. Nicholas Conrad of the University of Tübingen, in Germany, describes what is probably the oldest human statue yet discovered. It is 6cm tall. It is carved from a mammoth tusk. It dates from about 35,000 years ago. It was found in a cave in south-western Germany. And it is, not to put too fine a point upon the matter, obscene. As 35,000 years ago is reckoned the moment when modern man, Homo sapiens, arrived in Europe, this discovery adds to the evidence that human thinking—or male thinking, at least—has hardly changed since the species evolved.

Wolfram Alpha

The search is on

May 14th 2009
From The Economist print edition

A search engine that computes answers instead of looking them up

IT IS the curse of every internet search engine to be compared to Google, master of the universe and supreme ruler over two-thirds of such searches. Since newcomers never measure up to the breadth and depth of the billions of pages that Google has indexed over the past decade, most of these comparisons end with an easy win for the incumbent. Pretenders to the throne, nevertheless, keep appearing.

The latest, to be launched on May 18th, is Wolfram Alpha. It is named after its inventor, Stephen Wolfram, a British prodigy who earned his PhD in physics at the tender age of 20 and made a fortune from a calculation and graphing software package called Mathematica—and who raised eyebrows when he proposed, in a self-published tome in 2002, that the entire universe is but a giant calculator that has been running for billions of years.

To be fair, many of the overblown expectations surrounding Alpha do not stem from Dr Wolfram himself. Indeed, he describes his invention not as a search engine but as a “computational knowledge engine”. The quirky label is not only an attempt to sidestep a confrontation with Google, but also hints at Alpha’s different approach to answering questions.

Instead of serving up a list of popular links to other sites that contain the search term picked by a user, Alpha is a more-or-less closed system. It tries to dissect a question into its components and then performs calculations, using its own source materials, to compute an answer. The results are presented as a sleek collage of tables, charts and graphics. Alpha, in short, acts like a nerdy reference librarian who is equipped with the latest calculators and endless stacks of books and encyclopedias. Hit upon the right subject and it will excel at calculating airflow around a surface, showing the distribution patterns for DNA base pairs in human genes, spitting out prime numbers or computing and comparing crucial statistics for various national economies. Yet simple queries such as “climate change” or “Gordon Brown” will yield the equivalent of an empty stare.

Omniscient, omnipotent, omnipresent?

The goal Dr Wolfram has set himself is to take all the knowledge civilisation has amassed and make it computable—in other words, render it as potential inputs to logical queries that can be crunched to produce answers. A modest task, then, made no easier by the fact that knowledge is an ever-expanding realm, with plenty of soft spots that do not lend themselves to any sensible computation. In areas such as literature and popular culture, which are not based purely on formulas and numbers, Alpha is either still “under development” or entirely out of its depth. Even when there are facts, such as data about the expected range of global warming and its abatement, Alpha falters as soon as those facts become mired in debate.

The engine actually works by applying code used in Mathematica (a set of mathematical tools used to perform elaborate calculations, solve equations and build models) to a vast store of curated data that a team of around 200 experts working under Dr Wolfram’s direction has amassed, scanned, processed and correlated over the past couple of years. So far, he says, his repository contains between 10 billion and 20 billion elements of data.

This use of curated data means that Alpha takes a different approach to the automation or “crowdsourcing” normally used to generate knowledge from the web. In that sense it is more like (and may be more threatening to) Wikipedia than Google.

Dr Wolfram reckons his blend of machines and human minds can be scaled up to handle both the millions of users he hopes for and the thousands of employees who will be needed to add new sources of data by

hand, so that queries about the record sales of a rapper or the biography of a political figure do not go unanswered.

The result, according to some critics, is little more than a giant almanac (all those tables and charts). That is a bit harsh. A free service that almost instantaneously computes the answers to complex questions—such as the ratio between exports and imports in Ghana (or any other country) over the past ten years—is indeed novel, and may serve to help democratise expert knowledge. Alpha's true value, though, may become apparent only when outside organisations such as companies and universities can apply it to their own internal data as well as to Dr Wolfram's hoard. At that point it really will be able to get to work on all human knowledge.

Travel and creativity

Expats at work

May 14th 2009
From The Economist print edition

Living abroad gives you a creative edge

ANECDOTAL evidence has long held that creativity in artists and writers can be associated with living in foreign parts. Rudyard Kipling, Pablo Picasso, Ernest Hemingway, Paul Gauguin, Samuel Beckett and others spent years dwelling abroad. Now a pair of psychologists has proved that there is indeed a link.

As they report in the *Journal of Personality and Social Psychology*, William Maddux of INSEAD, a business school in Fontainebleau, France, and Adam Galinsky, of the Kellogg School of Management in Chicago, presented 155 American business students and 55 foreign ones studying in America with a test used by psychologists as a measure of creativity. Given a candle, some matches and a box of drawing pins, the students were asked to attach the candle to a cardboard wall so that no wax would drip on the floor when the candle was lit. (The solution is to use the box as a candleholder and fix it to the wall with the pins.) They found 60% of students who were either living abroad or had spent some time doing so, solved the problem, whereas only 42% of those who had not lived abroad did so.

A follow-up study with 72 Americans and 36 foreigners explored their creative negotiating skills. Pairs of students were asked to play the role of a seller of a petrol station who then needed to get a job and a buyer who would need to hire staff to run the business. The two were likely to reach an impasse because the buyer had been told he could not afford what the seller was told was his minimum price. Nevertheless, where both negotiators had lived abroad 70% struck a deal in which the seller was offered a management job at the petrol station in return for a lower asking price. When neither of the negotiators had lived abroad, none was able to reach a deal.

To check that they had not merely discovered that creative people are more likely to choose to live abroad, Dr Maddux and Dr Galinsky identified and measured personality traits, such as openness to new experiences, that are known to predict creativity. They then used statistical controls to filter out such factors. Even after that had been done, the statistical relationship between living abroad and creativity remained, indicating that it is something from the experience of living in foreign parts that helps foster creativity.

Merely travelling abroad, however, was not enough. You do have to live there. Packing your beach towel and suntan lotion will not, by itself, make you Hemingway.

Libel

Court behind

May 14th 2009
From The Economist print edition

“Evidence”: a scientific word—or a legal one?

BOGUS: counterfeit, spurious, sham. At least, that is what the “Oxford English Dictionary” says it means. And the exact meaning has taken on a painful importance for one of Britain’s best-known science writers—Simon Singh, the author of such tomes as “Fermat’s Last Theorem”, “Big Bang” and “The Code Book”.

Last year Dr Singh wrote an article in the *Guardian* about “chiropractic”, a type of alternative therapy used to try to treat back pain and ailments as varied as colic and ear infections in babies, by manipulating the spine. The article came out during “Chiropractic Awareness Week”, an event run by the British Chiropractic Association (BCA), and it set out to describe the evidence for chiropractic’s success, and also the risks involved.

Those risks, Dr Singh pointed out, include death. Laurie Mathiason, a 20-year-old Canadian, died in 1998, of “a ruptured vertebral artery, which occurred in association with a chiropractic manipulation of the neck”, according to the coroner. For back pain, the benefits (like those of conventional treatments) were mixed. But Dr Singh felt confident to say that for five childhood ailments, there was no evidence to support the BCA’s claims that chiropractic could treat them.

Unfortunately for him, his exact words were that the BCA “happily promotes bogus treatments”. The BCA sued for libel. And on May 7th Sir David Eady, a high-court judge, ruled, in a preliminary hearing, that the “natural and ordinary meaning” of the phrase (the relevant legal test) was that the BCA was being consciously dishonest and knowingly promoting quack treatments.

Rex Features



Dr Singh evaluates the evidence

The case has ramifications beyond science writing—and beyond England. “Bogus” is a word with many appealing applications when commenting on business and politics, and English courts are generous in their interpretation of jurisdiction. In 2005 Sir David accepted a libel case brought by a Saudi-born billionaire against an American, regarding a book never published in Britain. A few copies had been ordered online by British residents. The defendant lost.

Dr Singh could settle, which would cost over £100,000 ($150,000), mostly the BCA’s legal costs. Or he could appeal against Sir David’s ruling. That might be dicey, though. English appeal courts normally defer to first-instance judgments on meaning. But defending the case if the ruling stands is nearly impossible, because Dr Singh does not actually believe what he is held to have said. As he puts it, “I think alternative therapists who offer treatments unsupported by reasonable evidence are deluded rather than deliberately dishonest.”

Which is bad news for Dr Singh. It does not address the matter, though, of whether the treatments in question actually work.

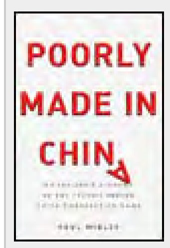
Chinese manufacturing

Poorly made

May 14th 2009
From The Economist print edition

Why so many Chinese products are born to be bad

Poorly Made in China: An Inside Account of the Tactics Behind China's Production Game
By Paul Midler



Wiley; 256 pages; $24.95 and £16.99

Buy it at
Amazon.com
Amazon.co.uk

Reuters



THE recent scandals about poisoned baby milk, contaminated pet food and dangerous toys from China have raised questions about manufacturing standards in the country that has become factory to the world. In China's defence, it was probably inevitable that as production grew so would the problems associated with it, at least in the short term. Similarly, it could be argued that China is going through the same quality cycle that occurred during Japan's post-war development or America's manufacturing boom in the late 19th century—but in an environment with infinitely more scrutiny.

A response to both these observations can be found in "Poorly Made in China" by Paul Midler, a fluent Chinese speaker who in 2001 moved to China to work as a consultant to the growing numbers of

Western companies now replacing factories in Europe and America with subcontracting relationships in the emerging industrial zone surrounding Guangzhou. It was the perfect period to arrive. The normal problems of starting a business, such as getting clients or providing a value proposition, do not hinder Mr Midler, who had the benefit of being in the right place at the right time.

Not only did he quickly, and seemingly effortlessly, find customers, they were delighted with what they found in China. Factories will do anything to please. Prices are famously low and production cycles short. His clients returned from their initial trips to China stunned by how quickly factories became proficient and puzzled by how much could be done so well, so fast, so cheaply. They were right to wonder.

Most of Mr Midler's work is coping with what he calls "quality fade" as the Chinese factories transform what were, in fact, profitless contracts into lucrative relationships. The production cycle he sees is the opposite of the theoretical model of continuous improvement. After resolving teething problems and making products that match specifications, innovation inside the factory turns to cutting costs, often in ways that range from unsavoury to dangerous. Packaging is cheapened, chemical formulations altered, sanitary standards curtailed, and on and on, in a series of continual product debasements.

In a further effort to create a margin, clients from countries with strong intellectual-property protection and innovative products are given favourable pricing on manufacturing, but only because the factory can then directly sell knock-offs to buyers in other countries where patents and trademarks are ignored. It is, Mr Midler says, a kind of factory arbitrage.

The first line of defence against compromised products are the factory's clients, the importers. The moment they begin suspecting a Chinese manufacturing "partner" and want to discover what might be unfolding is the moment they become particularly eager to find people in China like Mr Midler. That suggests they want information. But, as Mr Midler discovers, they are finicky about what is found. When suspicions turn out to be reality, all too often they become unhappy—miserable about resolving something costly and disruptive, yet terrified about being complicit in peddling a dangerous product. This is particularly true if the problems could go undetected by customers. Better, to some extent, not to know.

Aware of these dynamics, Western retailers increasingly use outside testing laboratories for Chinese products. But this too, Mr Midler writes, is more form than function, since the tests are by their very nature more limited than the ways to circumvent them. The process resembles the hunt for performance enhancements used by athletes, where a few get caught but the cleverer ones stay ahead by using products not yet on the prohibited list.

It would be unfair, of course, to see all Chinese companies in this light. A few are gaining international recognition for quality, but in contrast, say, to Japan or America, this recognition comes at a cost to the firms themselves because it is accompanied by unpopular scrutiny and compliance. This odd situation became apparent when Mr Midler witnessed large, modern Chinese factories outsourcing work to smaller, grittier, facilities even though this meant forgoing the production benefits from economies of scale. The tiny outfits were in a much better position to skirt environmental controls and safety standards for products and workers.

The obvious way to clean up this mess—and to know whether it is really as pervasive as this book suggests—is through broader disclosure, but by whom? The Chinese press is sometimes revealing but typically controlled, as are foreign reporters. Many production problems are well-known within local manufacturing circles, Mr Midler says, but collusion is rampant and there are no rewards in China for whistle-blowing. Most of the people in Mr Midler's position would not dream of disclosing what they see and many testing laboratories protect their reputation by hiding, rather than revealing, what they test. As a result, if Mr Midler's perceptions are true, the primary source of discovery will come in the worst possible way—by consumers who buy Chinese products, only to discover their flaws themselves.

Poorly Made in China: An Inside Account of the Tactics Behind China's Production Game.
By Paul Midler.
Wiley; 256 pages; $24.95 and £16.99

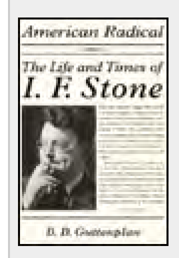
I.F. Stone's journalism

American muck-raker

May 14th 2009
From The Economist print edition

THE prediction that Isador Feinstein Stone, America's most celebrated investigative journalist, made to his wife proved right. "Honey", he told her, "I'm going to graduate from a pariah to a character, and then if I live long enough I'll be regarded as a national institution." He lived long enough. By the time he died in 1989 at the age of 81, I.F. "Izzy" Stone was embraced by a political and media establishment that had shunned him in his prime as, in his words, "a Red Jew son-of-a-bitch".

American Radical: The Life and Times of I.F. Stone
By D.D. Guttenplan



Farrar, Straus and Giroux; 592 pages; $35

Stone missed his enemies. He thrived on their hatred and came into his own in the 1950s when he was deprived of his passport, blacklisted by editors and subjected to physical surveillance by the FBI as a suspected Russian spy. Undeterred, he founded *I.F. Stone's Weekly*, a muck-raking journal that D.D. Guttenplan, his biographer, describes as the longest essay in single-handed journalism in American history. It came out for 19 years, ran to 3.5m words and hit a peak circulation of 70,000 that included just about everybody who mattered in Washington, DC.

Richard Nixon, then the vice-president, was among Stone's first targets as "a young man who symbolises a slick kind of Arrow-collared fascism" and remained in his sights until the Watergate scandal. Hollywood actors and others who defied McCarthyite demands to name communist associates could count on his support. So could black civil-rights activists. Many of Stone's weekly scoops came from his close reading of turgid government documents. He habitually quarried the end-notes and the smallest print. His exposure of the Pentagon's fabrications did much to foment opposition to the Vietnam war.

Stone's muck-raking continued a rich American tradition. He was inspired by journalists such as Lincoln Steffens and Ida Tarbell who exposed corruption in high places, and in turn inspired a younger generation. His influence can be seen in the Watergate scoops of Bob Woodward and Carl Bernstein, the revelation of the My Lai massacre in Vietnam by Seymour Hersh and the uncovering of multiple political and corporate misdeeds in the *Village Voice* by two of his fellow leftists, Alexander Cockburn and James Ridgeway.

Corbis

However, Stone's indignation about abuses of state power and infringements of civil liberties could be selective. He did not write a word in protest when in 1942 President Franklin Roosevelt signed an order that led to the internment of more than 110,000 Japanese-Americans and was happy to contemplate government actions against the far right that he deplored when directed at the far left. The excesses of the so-called permissive society appalled him. Liberals, he believed, betrayed the cause of freedom when they made "a fast and dirty buck" from pornography.

Stone was not a member of the Communist Party but he moved comfortably in party circles and, as an instinctual Popular Fronter, deplored factionalism on the left. Nonetheless, as Mr Guttenplan notes, Stone was an unusual "engaged" journalist. He listened carefully and took seriously the arguments of his opponents and sometimes even criticised his fellow leftists, especially those unwilling to admit the brutal tyranny of Stalinist Russia. His fellow Jews were criticised for not supporting the creation of a Palestinian homeland.

In his old age Stone found refuge from left-wing factionalism in classical literature. He read André Gide in French, Thomas Mann in German, the

Bible in Hebrew and wrote an investigative account of the trial of Socrates. Like his famous weekly, these were remarkable achievements for a college drop-out and a former pariah.


National institution

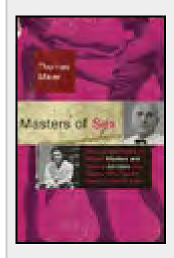
American Radical: The Life and Times of I.F. Stone.
By D.D. Guttenplan.
Farrar, Straus and Giroux; 592 pages; $35

Sex pioneers in America

So long in coming

May 14th 2009
From The Economist print edition

Masters of Sex: The Life and Times of William Masters and Virginia Johnson, the Couple Who Taught America How to Love
By Thomas Maier



Basic Books; 384 pages; $27.50 and £15.99

Buy it at
Amazon.com
Amazon.co.uk

WHEN William Masters was an associate professor of obstetrics at Washington University in the early 1950s, he wanted to see the library's one textbook on human sexual physiology. No dice. The book was regarded as possibly pornographic, and thus reserved for full professors. Actually, he would not have learnt much even if the librarians had been persuaded to slip him the volume in a brown paper bag. In those days people's sex organs were pretty much terra incognita, as a new biography of Masters and his research partner, Virginia Johnson, vividly explains.

Human sexual behaviour had been studied, since the late 1940s, by Alfred Kinsey, another American researcher. But Kinsey's work was sociological, not medical. He reported what people said they did to themselves and to each other. He did not investigate how any of it actually worked. The goings-on in the Masters and Johnson laboratory, by contrast, were audacious, rigorous and weird. Female volunteers masturbated with "Ulysses", a Plexiglass motorised dildo containing a camera, while wearing paper bags over their heads to preserve modesty. Hundreds of wired-up couples copulated under conditions of intense scrutiny. Over 12,000 orgasms were logged in the research for Masters and Johnson's first book, "Human Sexual Response", which was published in 1966. "Why", asked a laudatory editorial in the *Journal of the American Medical Association*, without a trace of irony, "was this study so long in coming?"

The researches of Masters and Johnson demolished Freudian ideas of female sexuality: there was nothing inferior about a clitorally induced orgasm. And women, unlike men, were naturally multi-orgasmic—given the right techniques. After their first book, Masters's and Johnson's work began to focus on treatments for sexual dysfunction. Here, as Masters acknowledged, it was the medically unqualified Ms Johnson who contributed most. Today's talking and touching therapies for couple's sexual problems are largely based on her ideas, just as the development of Viagra and its ilk owe much to the physiological research of Masters.

Early on in their partnership, Masters (who was married) persuaded Ms Johnson (a twice-divorced mother of two) to sleep with him. He argued that this would help to avoid the worse sin of becoming sexually involved with their patients. She agreed, because she wanted to keep her job. By 1970, the tables had turned and it was Masters who feared an end to their professional partnership. Ms Johnson was on the brink of marrying a rich patron of their institute, so Masters suddenly divorced his wife, in an apparent bid to keep Ms Johnson from leaving. Ms Johnson married Masters the next year. It is not clear why she did so, as they were not in love; she said she did not know why she married her first husband, either. At the end of 1992, Masters suddenly decided it was time to change partners again, divorced Ms Johnson, and then married a long-lost sweetheart of his youth, whom he believed (mistakenly, as it turned out) had jilted him a half-century earlier. If there is a moral to this tale, it is perhaps that the human heart remains as much of a mystery as the sex organs once used to be.

Masters of Sex: The Life and Times of William Masters and Virginia Johnson, the Couple Who Taught America How to Love.
By Thomas Maier.
Basic Books; 384 pages; $27.50 and £15.99

The lost people of Central Asia

Out of steppe

May 14th 2009
From The Economist print edition

Out of Steppe: The Lost Peoples of Central Asia
By Daniel Metcalfe



Hutchinson; 352 pages; £18.99

Buy it at
Amazon.com
Amazon.co.uk

DRENCHED with history and exoticism, Central Asia has long attracted outsiders for good reasons and bad. The Bolshevik revolution ended a long tussle between British and Russian geopolitical ambitions, nailing the region down inside the Soviet empire. It also imposed a communist-style modernity that eroded, sometimes savagely, its peculiar ethnicities and ancient religions.

The theme of Daniel Metcalfe's sardonic but sympathetic travelogue is of loss. Having learnt Persian in Tehran (he makes it sound as easy as learning to play snooker) he sets off for Turkmenistan and Uzbekistan, two Central Asian despotisms where the collapse of Soviet rule has accelerated depopulation and man-made ecological disaster. Readers may never have heard of the dwindling and maltreated Karakalpak people before, but after a few of Mr Metcalfe's leanly written pages, they will care a lot.

It is the same story with the other lost tribes he tracks down: the Jews of Bukhara, the Germans of Kazakhstan and the Yaghnobi people of Tajikistan. The Yaghnobi are the last fragment of a race of scholar-traders who ran Central Asia in the glory days of the Silk Road. Deported and all but exterminated in the 1960s, they invite Mr Metcalfe to a circumcision feast and tell him stories about magicians who turn people into cats.

Mr Metcalfe is a modest writer who pays due homage to long-forgotten predecessors such as Ella Maillart, a free-spirited Swiss sportswoman who chronicled the savage collectivisation of Karakalpak agriculture in the early 1930s. He makes light of the difficulties, delays and discomforts of voyaging through a part of the world where bureaucrats and bedbugs plague the traveller. Moreover, unlike some travel writers he is refreshingly honest about the tricks he plays, reflecting harshly on the moral weakness that leads him, briefly, to feign a Jewish identity in order to win the trust of the surviving Jews of Bukhara.

His travels end in Pakistan and Afghanistan, where the levelling force is not communism but Islam. One of his many poignant stories is of a Kalasha shaman whose relatives converted him to Islam while he was unconscious in hospital. There is no way back: apostasy would risk murder. So he now practises his craft in secrecy and with difficulty. “My power is not the same,” he confides. “I can't fall into a trance so easily. The angels are angry with me.”

“Out of Steppe” is enterprising and finely written, if on occasion a shade precious. Mr Metcalfe, a polyglot Oxford classicist, strikes an exotic figure in what used to be called Turkestan. He can justly be compared with British adventurers such as Robert Byron, the interwar traveller who wrote the “Road to Oxiana”. But for readers whose talents are less glittering, a gushing dust jacket note that the author “never travels without his mandolin” may be a little much.

Out of Steppe: The Lost Peoples of Central Asia.
By Daniel Metcalfe.
Hutchinson; 352 pages; £18.99

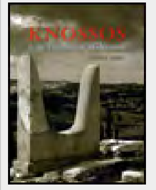
Greek archaeology

Making merry at Knossos

May 14th 2009
From The Economist print edition

ARCHAEOLOGY is an inexact science, as Sir Arthur Evans, a flamboyant early practitioner, knew. However painstaking the digging process, an excavator can always promote an extravagant theory under the guise of interpreting the finds.

Knossos and the Prophets of Modernism
By Cathy Gere



University of Chicago Press; 277 pages; $27.50 and £19

Buy it at
Amazon.com
Amazon.co.uk

Illustration by Daniel Pudles

As he started to unearth a prehistoric mound at Knossos in Crete at the turn of the 20th century, Evans put his imagination into high gear. He rebuilt parts of a 3,500-year-old palace in modernist style using cement and reconstructed fragmentary frescoes to suit his views on Bronze Age religion and politics.

Evans boldly argued that the Minoans, as he called the early islanders, shunned warfare, conveniently forgetting about the ruined watchtowers and fortification walls he had already identified elsewhere in Crete. In public lectures and a stream of articles after the first world war he presented a vision of a lost island paradise. Disillusioned artists and intellectuals were entranced by the idea of Minoans living close to nature, playfully leaping over bulls and worshipping a benign mother goddess.

Among those who swallowed the Knossos myth were Sigmund Freud, James Joyce and Pablo Picasso, though none of them visited the site. Others who toured the reconstructed palace, including Evelyn Waugh, were more sceptical. Yet the magic persisted. A later generation, among them Crete's 1960s hippy residents, saw the Minoans as an early blueprint for feminism and anti-war protests.

Cathy Gere, a British academic, has written a stylish and original cultural history of Knossos, which slots Evans and the Minoans into a broader, modernist world. Anxiety is always present. The Minoans' most fervent admirers, Ms Gere notes, were all "trying to make sense of some of the weightiest themes of modernity—the death of God, the woman question, the human appetite for war."

Evans's own pacifism was inspired by his experience of covering anti-Turkish rebellions in the Balkans as a correspondent for the *Manchester Guardian*. At Knossos he hired both Muslim and Christian workmen. Once a year he made them dance together in the ruins, a private reconciliation effort after a brutal episode of ethnic cleansing in Crete.

Contrary to Evans's flowery interpretation, the Minoans appear to have been as bloodthirsty as other early eastern Mediterranean societies. Two excavations in 1982 revealed evidence of human sacrifice outside a village close to Knossos, and of ritual cannibalism involving children in a town-house close to the palace. In the 1990s Greek and foreign researchers re-explored the network of military roads and watchtowers in eastern Crete that Evans had chosen to ignore. Studies of Bronze Age weaponry showed that Cretan sword and dagger designs were widely copied. For all their playfulness, the Minoans were serious about waging war.

Knossos and the Prophets of Modernism.
By Cathy Gere.
University of Chicago Press; 277 pages; $27.50 and £19

New film at Cannes

Francis Ford Coppola's “Tetro”

May 14th 2009
From The Economist print edition

The director of “The Godfather” is back at the helm

FRANCIS FORD COPPOLA, who turned 70 last month, says that “Tetro” is the kind of film he set out to make as a young man, before fame and fortune sidetracked him. Showing at this year’s Cannes film festival, which opened on May 13th, “Tetro” is Mr Coppola’s second feature after ten years of silence and only the fourth he has made from a story of his own devising. One of these, “Dementia 13”, his youthful axe-murder opus, is referred to in “Tetro” when his protagonist arrives at a prize ceremony carrying an axe.

Tetro (Vincent Gallo), whose real name is Angelo, is not fond of fame. His father, Carlo Tetrocini (Klaus Maria Brandauer), is a monster from whom Tetro has fled to Buenos Aires on a “writing sabbatical”. Here for the past ten years he has been working in a theatre unable to finish his magnum opus.

Tetro keeps his past a secret even from Miranda (Maribel Verdú), the woman he loves, until the unwelcome arrival of his younger brother Bennie, played by 18-year-old Alden Ehrenreich, whose fresh-faced innocence masks a streak of stubbornness. Determined to save his adored older brother, Bennie brings the past with him, although as Tetro’s new name indicates, it never really went away.

Filmed in black and white with few camera movements, “Tetro” reminds the audience of what Mr Coppola can do with actors when he isn’t distracted by technique. Apart from Carmen Maura, playing a powerful critic who has turned her back on Tetro, her former protégé, the supporting players are young actors he cast locally in Argentina. They bring lightness and humour to a dark story of family secrets and rivalries that the director has mined from the imposing mythology of the Coppola family.

Tetro



Every family has a secret

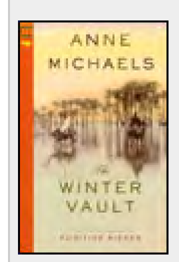
One plotline evokes the story of the living doll who is torn to pieces by the wizard Coppelius in “The Tales of Hoffmann”. When Bennie begins to understand why his brother took him to see Michael Powell’s film of “Hoffmann” as a boy, he imagines scenes from Tetro’s story as colour ballet sequences filmed in Mr Powell’s style. Like Tetro’s past, Mr Coppola’s brilliance as a visual stylist can’t stay hidden for long. Here it is in the service of a story told by a master, with no concessions—the film of a free man starting again.

New fiction

Anne Michaels's "The Winter Vault"

May 14th 2009
From The Economist print edition

The Winter Vault
By Anne Michaels



Knopf; 352 pages; $25. Bloomsbury; £16.99

Buy it at
Amazon.com
Amazon.co.uk

READERS of Anne Michaels's first novel, "Fugitive Pieces", will recognise the world of her new book, "The Winter Vault". It is easy enough to say that they are both about landscape and exile, memory and grief. But it is the tightness with which Ms Michaels knots these things together that marks her novels out. "Nothing exists independently," says a character in "The Winter Vault", "not a single molecule, not a thought."

The book opens in 1964, with the dismantling and "rescue" of Abu Simbel, the ancient Nubian temple beside the Nile, threatened by Gamal Abdul Nasser's huge hydro-electric dam at Aswan. One of the central characters, Avery Escher, is a mechanical engineer who has previously worked on the great dam at Lake St Lawrence in Ontario. Now in Egypt, he and his Canadian wife Jean, a botanist, have come to believe that both these projects, with their flooded villages and forced migrations, are a desecration, a kind of death.

They feel too that reconstructions and replicas are essentially fraudulent. The dismembered temple may be perfectly reassembled, but it is without its spirit; Nubian villages are relocated, but without the sacred Nile.

That, in brief, is the theme of "The Winter Vault". The book circles and broods, transferring meanings between landscape and people with a fluidity that almost dissolves boundaries. Avery's paint brushes, dipped in Nile water, wash the Chiltern hills of his childhood on to Jean's naked back as she lies on the deck of their houseboat. The moment is repeated at the end, but with a difference. The book is full of such differences, half-echoes, re-imaginings, changes in the light.

At its centre is Jean's abortive pregnancy, a fetus dead at seven months which, as Abu Simbel awaits its own false rebirth, she is told she must carry to term. It marks a descent for her, a temporary parting from Avery, and a tentative, questing affair with Lucjan, a Canadian-Polish-Jewish artist, whose memories of growing up in wartime Warsaw introduce her to the earliest of all the book's destructions.

"The Winter Vault" is as much about love as grief. The main characters are tender, thoughtful, always searching the moment, the precise detail, and the seed of metaphor within it. One character talks of being "intimate with immensity". Ms Michaels finds a language to attempt that.

The Winter Vault.
By Anne Michaels.
Knopf; 352 pages; $25. Bloomsbury; £16.99

Margaret Gelling

May 14th 2009
From The Economist print edition

Margaret Gelling, an expert on English place names, died on April 24th, aged 84





AT WIVENHOE, in Essex, the low line of the hills has the shape of the heels of a person lying face-down. The name contains the shape: a *hoh* is a ridge that rises to a point and has a concave end. At Wooller in Northumberland, however, the hilltop is level, with a convex sloping shoulder. The hidden word here is *ofer*, "a flat-topped ridge". Early Anglo-Saxon settlers in England, observing, walking and working the landscape, defined its ups and downs with a subtlety largely missing from modern, motorised English. Dozens of words, none of them synonymous, described the look of a hill, the angle of slope and the way trees grew upon it. And after the Anglo-Saxons, no one looked at the landscape in quite that way until Margaret Gelling.

She was a neat, keen, merry woman, "prissy" as she described herself, and sensibly shod and clad. The gear was appropriate for slopping through *slæp*, *fenn*, *myrr* and *slohtre* (the disappointing origin of Upper and Lower Slaughter), or stomping through *leah*, *hurst*, *holt* and *græfe*, where trees were felled and coppiced and axes rang in the woods. Though she spent much of the time with her nose in one-inch Ordnance Survey maps, tracking the contour lines, she found them a "coarse instrument" for her purpose. When it came to understanding English place names, there was no substitute for donning your wellies and using your eyes.

Mrs Gelling worked for the English Place-Name Society, formally and informally, from 1946. From 1986 to 1998 she was its president. She never held an academic post, but lectured widely, wrote a dozen books and produced three of the county surveys of place names. She was devoted to the proposition that names drawn from the landscape were not trivial or accidental, but original and important. All her passion for argument was employed to prove that *hamm*, a piece of land almost enclosed by water, was as vital a suffix as *ham*, a man-made enclosure; that an ending in *-den* might come from *denu*, a long and sinuous valley, rather than *denn*, a woodland pig-pasture; and that the *hall* in Coggeshall came from *halh*, a nook or a hollow, not some grand building. Cogg's nook, a little recess tucked into the 150-foot contour line, was perhaps the best place where he could put his hut. With Mrs Gelling, topography always came first.

No subtlety escaped her. The suffix *fyrhth* was not simply wood, but "scrubland at the edge of the

forest”. The word *wæss* was not just swamp, but—she was particularly proud of this—“land by a meandering river which floods and drains quickly”. She had observed this herself at Buildwas, on the winding Severn in Shropshire, where between Saturday morning and Sunday afternoon the flooding river drained from the land “as if a plug had been pulled out”. A *feld* was not necessarily ground broken for arable, but any open country in the almost all-covering fifth-century forest. And an *ærn* was not merely a house, but a place where something was stored in bulk and worked on: so that Brewerne, in Cambridgeshire, acquired a smell of beer, and Colerne, in Wiltshire, a dusting of charcoal.

Reading Spaghetti Junction

This “obsession”, as she happily called it, seemed to have begun at St Hilda’s in Oxford, where she found her English course boring, but was encouraged by Dorothy Whitelock to look at place names. They appealed immediately to the socialist, even communist, instincts with which she liked to shock her parents. Most of the place names of England had been bestowed not by officialdom, or in deference to knights, earls or kings, but by ordinary peasants coping with flooded pasture or looking over the hills. That habit had long died out; but as a resident of Birmingham (“village of Beorma’s people”) for most of her life, she liked to think that Spaghetti Junction, the giant intersection of roads just north of the city, was a solitary modern example of the will of the people expressed in a name.

She was less egalitarian when it came to the business of sorting out what names meant. There were too many snares and snags involved “to invite general participation in the process of suggesting etymologies”. Who, for example, would catch that Chiswick and Keswick both meant “cheese-farm”, or that the tasty-sounding Fryup, in Yorkshire, meant “Frig’s remote valley”? Who could safely sort out *ea*, as in Eton, meaning a river, from *ey*, Old Norse for island? Who would dare to hazard a meaning for Wixhill and Wingfield, if she herself left them as “obscure”?

Nonetheless, she was grateful when locals got in touch with her: telling her, for example, that the stream at Winsor in Hampshire was too tiny to carry the meaning, “river-bank where boats are pulled by a windlass”, she had posited for Windsor in Berkshire. She was delighted to think that the public, reading her books, would suddenly learn to read their habitat, and see it with completely different eyes. At Hartside in Cumbria, for example, a white deer would suddenly flash through the woods; at Earley, in Berkshire, white-tailed eagles would fly above a clearing. And better still, in the soulless suburbs of south London, Penge now marked “the wood’s end”, and Croydon became “the valley where wild saffron grows”.

Overview

May 14th 2009
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In **America** the nascent recovery in consumer spending is faltering. The value of retail sales fell by 0.4% in April, following a 1.3% decline in March. Sales were 10.1% lower than in April 2008. The unemployment rate rose from 8.5% to 8.9% in April, the highest in a quarter of a century. American employers, excluding farms, cut 539,000 jobs from their payrolls in April. The loss was smaller than in each of the previous five months. In March payrolls fell by 699,000.

Industrial production in **China** is slowing but still robust. Output rose by 7.3% in the year to April, compared with an 8.3% rise in the year to March. Car sales in China rose above the 800,000 mark, a new record, in April. Sales were 37% higher than a year earlier, helped by tax breaks on car purchases. Consumer prices fell by 1.5% in the year to April.

Britain's unemployment rate rose to 7.1% in the three months to March from 6.3% in the fourth quarter. Average earnings fell by 0.4% in the first quarter compared with the same period a year earlier, reflecting a sharp fall in bonus payments. Industrial production fell by 5.3% in the three months to March, the biggest quarterly drop since 1974. The Bank of England said that economic recovery may be slower to arrive than in past downturns. The Bank forecasts that inflation will be below the government's 2% target for most of the next three years.

Industrial output in the **euro area** fell by 2% in March, leaving it more than a fifth lower than in March 2008.



Output, prices and jobs

May 14th 2009
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2009†	2010†	latest	latest	year ago	2009†	rate‡, %
United States	−2.6 Q1	−6.1	−2.9	+1.4	−12.8 Mar	−0.4 Mar	+4.0	−0.8	8.9 Apr
Japan	−4.3 Q4	−12.1	−6.4	+0.6	−34.2 Mar	−0.3 Mar	+1.2	−1.1	4.8 Mar
China	+6.1 Q1	na	+6.5	+7.3	+7.3 Apr	−1.5 Apr	+8.5	−0.5	9.0 2008
Britain	−4.1 Q1	−7.4	−3.7	+0.3	−12.4 Mar	+2.9 Mar§	+2.5	+1.5	7.1 Mar††
Canada	−0.7 Q4	−3.4	−2.3	+1.6	−7.6 Feb	+1.2 Mar	+1.4	+0.5	8.0 Apr
Euro area	−1.5 Q4	−6.2	−3.7	+0.3	−20.2 Mar	+0.6 Apr	+3.3	+0.4	8.9 Mar
Austria	+0.5 Q4	−0.8	−2.1	+0.2	−14.2 Feb	+0.8 Mar	+3.5	+0.6	4.5 Mar
Belgium	−3.0 Q1	−6.2	−3.0	+0.2	−18.6 Feb	+0.6 Apr	+4.2	+0.6	11.2 Feb‡‡
France	−1.1 Q4	−4.4	−2.9	+0.3	−15.8 Mar	+0.1 Apr	+3.0	+0.2	8.8 Mar
Germany	−1.7 Q4	−8.2	−5.2	+0.3	−20.3 Mar	+0.7 Apr	+2.4	+0.2	8.1 Mar
Greece	+2.4 Q4	+1.2	−3.6	−1.1	−5.3 Mar	+1.0 Apr	+4.4	+0.9	9.4 Jan
Italy	−2.9 Q4	−7.5	−4.0	+0.1	−23.8 Mar	+1.3 Apr	+3.3	+0.7	6.9 Q4
Netherlands	−0.6 Q4	−3.8	−3.1	+0.5	−12.1 Mar	+1.8 Apr	+2.0	+0.9	4.1 Mar††
Spain	−2.9 Q1	−7.0	−3.3	−0.5	−14.0 Mar	−0.2 Apr	+4.2	−0.1	17.4 Mar
Czech Republic	+0.7 Q4	−3.7	−3.0	+1.2	−17.0 Mar	+1.8 Apr	+6.8	+1.8	7.9 Apr
Denmark	−3.7 Q4	−7.3	−3.1	+0.6	−15.0 Mar†††	+1.4 Apr	+3.2	+1.2	2.9 Mar
Hungary	+2.0 Q4	−3.9	−6.0	−1.0	−19.6 Mar	+3.4 Apr	+6.6	+2.8	9.7 Mar††
Norway	+0.8 Q4	+5.6	−2.0	+0.5	−1.6 Mar	+2.9 Apr	+3.1	+1.9	3.1 Feb***
Poland	+2.9 Q4	na	−0.4	+1.8	−2.0 Mar	+3.6 Mar	+4.1	+3.0	11.2 Mar‡‡
Russia	+1.2 Q4	na	−3.0	+2.0	−13.7 Mar	+13.2 Apr	+14.3	+13.8	10.0 Mar‡‡
Sweden	−4.9 Q4	−9.3	−4.1	+0.8	−22.9 Mar	+0.1 Apr	+3.4	−0.2	8.3 Mar‡‡
Switzerland	−0.1 Q4	−1.2	−2.4	+0.2	−6.0 Q4	−0.3 Apr	+2.3	−0.5	3.4 Apr
Turkey	−6.2 Q4	na	−4.4	+1.0	−20.9 Mar	+6.1 Apr	+9.7	+6.8	13.6 Q4‡‡
Australia	+0.3 Q4	−2.1	−0.7	+1.6	−0.7 Q4	+2.5 Q1	+4.2	+2.0	5.4 Apr
Hong Kong	−2.5 Q4	−7.8	−5.9	−0.3	−10.3 Q4	+1.2 Mar	+4.1	+0.9	5.2 Mar††
India	+5.3 Q4	na	+5.0	+6.4	−2.3 Mar	+9.6 Feb	+5.5	+5.0	6.8 2008
Indonesia	+5.2 Q4	na	−1.4	+0.5	−2.4 Feb	+7.3 Apr	+6.8	+4.2	8.4 Aug
Malaysia	+0.1 Q4	na	−3.0	+1.1	−14.3 Mar	+3.5 Mar	+2.8	−0.7	3.0 Q4
Pakistan	+5.8 2008**	na	+0.6	+3.2	−7.9 Feb	+17.2 Apr	+17.2	+9.9	5.6 2007
Singapore	−11.5 Q1	−19.7	−8.8	+0.9	−33.9 Mar	+1.6 Mar	+6.7	+0.1	3.2 Q1
South Korea	−4.3 Q1	+0.2	−5.9	+0.3	−10.6 Mar	+3.6 Apr	+4.1	+0.1	3.7 Apr
Taiwan	−8.4 Q4	na	−9.3	+0.1	−26.0 Mar	−0.5 Apr	+3.9	−1.6	5.7 Mar
Thailand	−4.3 Q4	−22.2	−4.4	+1.4	−15.4 Mar	−0.9 Apr	+6.2	−1.2	2.4 Jan
Argentina	+4.9 Q4	−1.2	−3.0	+1.5	−0.9 Mar	+5.7 Apr	+8.9	+6.2	7.3 Q4‡‡
Brazil	+1.3 Q4	−13.6	−1.5	+2.7	−10.0 Mar	+5.5 Apr	+5.0	+4.4	9.0 Mar‡‡
Chile	+0.2 Q4	−8.3	−0.5	+2.4	−7.1 Mar	+4.5 Apr	+8.3	+3.0	9.2 Mar††‡
Colombia	−0.7 Q4	−4.1	−3.0	+1.5	−12.8 Feb	+5.7 Apr	+5.7	+5.4	12.0 Mar‡‡
Mexico	−1.6 Q4	−10.3	−4.4	+1.2	−13.2 Feb	+6.2 Apr	+4.6	+5.0	4.8 Mar‡‡
Venezuela	+3.2 Q4	na	−5.0	−5.4	−0.9 Jan	+29.4 Apr	+29.3	+30.3	8.1 Q1‡‡
Egypt	+4.3 Q1	na	+3.6	+3.7	+5.7 Q4	+11.7 Apr	+16.4	+9.1	9.4 Q1‡‡
Israel	+1.2 Q4	−0.5	−0.8	+2.0	−1.7 Feb	+3.6 Mar	+3.7	+0.7	6.3 Q4
Saudi Arabia	+4.2 2008	na	−1.0	+3.3	na	+6.0 Mar	+8.3	+4.3	na
South Africa	+1.0 Q4	−1.8	−1.8	+3.1	+8.5 Mar	+8.5 Mar	+10.6	+6.0	23.5 Mar‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−15.6 Q1	na	−10.0	−2.5	−29.7 Mar	+0.3 Apr	+11.4	+0.5	9.9 Feb
Finland	−2.4 Q4	−5.0	−5.1	−1.3	−16.5 Mar	+0.8 Apr	+3.6	+0.7	7.6 Mar
Iceland	−1.3 Q4	−3.6	−12.4	−0.9	+0.4 2007	+11.9 Apr	+11.8	+12.5	8.9 Mar‡‡
Ireland	−7.5 Q4	−25.7	−7.3	−2.6	−1.7 Feb	−2.6 Mar	+5.0	−3.5	11.4 Apr
Latvia	−18.0 Q1	na	−15.0	−4.0	−23.4 Mar	+6.4 Apr	+17.4	+2.5	14.4 Feb
Lithuania	−12.6 Q1	−32.9	−10.0	−2.5	na	+6.3 Apr	+11.7	+4.5	9.5 Mar‡‡
Luxembourg	−5.2 Q4	−16.8	−4.0	−0.5	−36.1 Feb	+0.3 Mar	+3.5	+0.5	5.5 Mar‡‡
New Zealand	−2.3 Q4	−2.3	−3.2	+0.7	−0.5 Q3	+3.0 Q1	+3.4	+1.6	5.0 Q1
Peru	+0.2 Feb	na	+2.8	+3.9	−7.4 Feb	+4.6 Apr	+5.5	+4.7	9.3 Mar‡‡
Philippines	+4.5 Q4	+4.1	−1.9	+1.4	−21.1 Feb	+4.8 Apr	+8.3	+1.9	7.7 Q1‡‡
Portugal	−1.8 Q4	−6.2	−4.2	−0.5	−7.6 Mar	−0.5 Apr	+2.5	−1.0	7.8 Q4††
Slovakia	+2.5 Q4	na	−2.0	+1.0	−18.0 Mar	+2.3 Apr	+4.2	+2.0	10.3 Mar‡‡
Slovenia	−0.8 Q4	na	−3.0	+1.1	−18.5 Mar	+1.1 Apr	+6.5	+1.1	8.2 Feb‡‡
Ukraine	+6.9 Q3	na	−6.0	+2.0	−30.4 Mar	+15.6 Apr	+30.2	+16.6	3.1 Mar
Vietnam	+5.5 Q4	na	+1.6	+2.0	+2.4 Mar	+11.2 Mar	+19.4	+4.8	4.6 2007

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions. §RPI inflation rate -0.4 in Mar. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average †††New series

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

The Economist commodity-price index

May 14th 2009
From The Economist print edition

The Economist commodity-price index
2000=100

	May 5th	May 12th*	% change on one month	% change on one year
Dollar index				
All items	176.2	181.7	+6.9	−29.5
Food	199.8	206.5	+7.8	−19.5
Industrials				
All	145.7	149.5	+5.2	−42.2
Nfa†	126.2	129.9	+6.5	−34.3
Metals	156.3	160.3	+4.6	−45.2
Sterling index				
All items	177.2	180.4	+4.3	−10.1
Euro index				
All items	122.0	123.1	+3.8	−20.0
Gold				
$ per oz	904.30	920.00	+3.5	+5.9
West Texas Intermediate				
$ per barrel	53.81	58.82	+18.9	−53.3

*Provisional †Non-food agriculturals.

Taxing wages

May 14th 2009
From The Economist print edition



The OECD's annual survey of employment taxes takes a close look at the "tax wedge", the difference between the cost of labour to employers and what employees receive as take-home pay. It is made up of income tax and the contributions paid to social-security funds by firms and workers. Other things being equal, the bigger the tax wedge, the harder it is to create jobs. In the 2008 survey the wedge went up in 15 of the OECD member states and fell in the remaining 15. In Hungary and Germany the wedge is over 50% of total labour cost, though it fell last year. In Turkey a three percentage-point cut took the tax wedge below 40%. Income-tax cuts in Spain and Britain slimmed their tax wedges by around 1.2 percentage points.



Trade, exchange rates, budget balances and interest rates

May 14th 2009
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2009†	Currency units, per $ May 13th	Currency units, per $ year ago	Budget balance % of GDP 2009†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−730.4 Mar	−673.3 Q4	−3.3	–	–	−13.1	0.20	3.10
Japan	+10.0 Mar	+118.2 Mar	+1.6	96.1	105	−6.3	0.49	1.45
China	+300.5 Apr	+400.7 Q2	+6.9	6.82	7.00	−3.5	1.21	3.37
Britain	−156.7 Mar	−44.6 Q4	−1.7	0.66	0.52	−12.3	1.35	3.51
Canada	+32.7 Mar	+11.3 Q4	−2.0	1.17	1.00	−2.5	0.19	3.25
Euro area	−59.4 Feb	−150.9 Feb	−1.0	0.74	0.65	−5.7	1.28	3.34
Austria	−3.9 Feb	+15.0 Q4	+1.7	0.74	0.65	−4.6	1.28	4.02
Belgium	+8.2 Jan	−12.1 Dec	−1.8	0.74	0.65	−4.7	1.30	3.98
France	−79.1 Mar	−53.6 Mar	−2.3	0.74	0.65	−6.6	1.28	3.73
Germany	+223.3 Mar	+193.7 Mar	+4.4	0.74	0.65	−4.4	1.28	3.34
Greece	−61.1 Feb	−48.7 Feb	−12.8	0.74	0.65	−5.0	1.28	5.20
Italy	−15.7 Feb	−72.9 Feb	−2.6	0.74	0.65	−5.3	1.28	4.30
Netherlands	+50.2 Feb	+65.3 Q4	+5.9	0.74	0.65	−3.1	1.28	3.79
Spain	−127.3 Feb	−144.9 Feb	−6.9	0.74	0.65	−9.6	1.28	3.96
Czech Republic	+4.0 Mar	−7.2 Feb	−2.2	19.7	16.2	−3.6	2.52	5.32
Denmark	+6.0 Feb	+8.0 Mar	+1.0	5.47	4.83	−2.5	2.68	3.72
Hungary	+0.1 Mar	−13.0 Q4	−3.0	209	162	−2.9	9.69	9.95
Norway	+70.5 Mar	+83.4 Q4	+10.5	6.51	5.08	10.5	2.39	4.07
Poland	−22.2 Feb	−25.5 Feb	−5.1	3.27	2.19	−3.2	4.42	3.38
Russia	+151.6 Mar	+75.4 Q1	−1.1	32.0	23.9	−8.0	12.00	10.96
Sweden	+13.7 Mar	+40.3 Q4	+7.1	7.88	6.02	−4.7	0.40	3.54
Switzerland	+16.9 Mar	+53.3 Q4	+7.5	1.11	1.06	−2.0	0.40	2.29
Turkey	−58.1 Mar	−30.5 Mar	−1.3	1.57	1.25	−4.4	10.22	7.09†
Australia	+5.2 Mar	−44.1 Q4	−5.0	1.32	1.07	−3.3	3.11	4.93
Hong Kong	−23.8 Mar	+30.6 Q4	+8.1	7.75	7.80	−4.0	0.72	2.16
India	−109.0 Mar	−37.5 Q4	−3.0	49.7	42.4	−7.7	3.14	7.46
Indonesia	+7.3 Mar	+0.6 Q4	−0.3	10,340	9,295	−2.9	8.42	7.94‡
Malaysia	+43.5 Mar	+39.1 Q4	+10.2	3.53	3.27	−8.7	2.09	2.68‡
Pakistan	−17.8 Apr	−15.3 Q4	−1.3	80.8	68.8	−6.4	13.24	17.03†
Singapore	+16.3 Mar	+27.1 Q4	+17.2	1.46	1.38	−4.1	0.56	2.04
South Korea	+3.3 Apr	+7.4 Mar	+1.9	1,244	1,047	−6.5	2.41	4.95
Taiwan	+11.2 Apr	+25.0 Q4	+11.1	32.9	31.0	−5.3	0.85	1.46
Thailand	+7.8 Mar	+5.9 Mar	+2.0	34.5	32.5	−4.7	1.45	2.83
Argentina	+13.6 Mar	+7.6 Q4	+1.1	3.72	3.16	−0.8	14.44	na
Brazil	+27.0 Apr	−23.0 Mar	−1.2	2.10	1.66	−2.0	10.15	6.16†
Chile	+3.8 Apr	−3.4 Q4	−3.8	572	468	−3.4	1.80	3.31‡
Colombia	+2.1 Feb	−6.8 Q4	−4.0	2,261	1,789	−3.3	6.58	6.22‡
Mexico	−17.2 Mar	−2.4 Q4	−3.5	13.3	10.5	−5.3	5.36	7.64
Venezuela	+39.2 Q4	+39.2 Q4	+0.4	6.55	3.53§	−5.3	16.09	6.55‡
Egypt	−26.8 Q4	−1.3 Q4	−0.8	5.62	5.36	−6.9	10.43	2.97†
Israel	−12.0 Mar	+1.6 Q4	+2.0	4.13	3.42	−5.9	0.36	3.70
Saudi Arabia	+197.4 2008	+124.0 2008	−8.4	3.75	3.75	−9.0	0.92	na
South Africa	−7.4 Mar	−21.0 Q4	−5.5	8.52	7.63	−4.0	8.03	8.63
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−3.2 Feb	−1.8 Feb	−3.0	11.5	10.1	−3.5	6.27	na
Finland	+8.0 Feb	+3.4 Feb	+0.6	0.74	0.65	−4.1	1.30	3.81
Iceland	+0.2 Apr	−5.6 Q4	+0.4	127	78.9	−10.5	8.13	na
Ireland	+45.0 Feb	−12.7 Q4	−2.5	0.74	0.65	−12.0	1.28	5.07
Latvia	−5.2 Feb	−3.5 Feb	−4.0	0.52	0.45	−6.0	11.62	na
Lithuania	−5.4 Mar	−5.1 Feb	−3.0	2.54	2.23	−3.5	6.84	na
Luxembourg	−7.8 Feb	+3.0 Q4	na	0.74	0.65	−4.5	1.28	na
New Zealand	−3.3 Mar	−11.3 Q4	−6.7	1.68	1.31	−6.3	3.95	5.53
Peru	+2.0 Mar	−4.2 Q4	−5.9	3.04	2.76	−1.8	4.00	na
Philippines	−7.8 Feb	+4.2 Dec	+2.0	47.4	42.9	−2.7	4.06	na
Portugal	−33.0 Feb	−27.7 Feb	−9.7	0.74	0.65	−4.9	1.28	4.21
Slovakia	−1.0 Mar	−7.1 Feb	−6.2	22.1	20.5	−4.0	1.35	4.64
Slovenia	−4.1 Mar	−2.5 Feb	−1.6	0.74	0.65	−3.8	1.28	na
Ukraine	−16.9 Q4	−10.1 Q1	−2.2	7.73	4.80	−4.0	14.70	na
Vietnam	−8.2 Mar	−7.0 2007	−1.8	17,773	16,160	−8.2	7.80	7.55

*Merchandise trade only. †The Economist poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.

Markets

May 14th 2009
From The Economist print edition

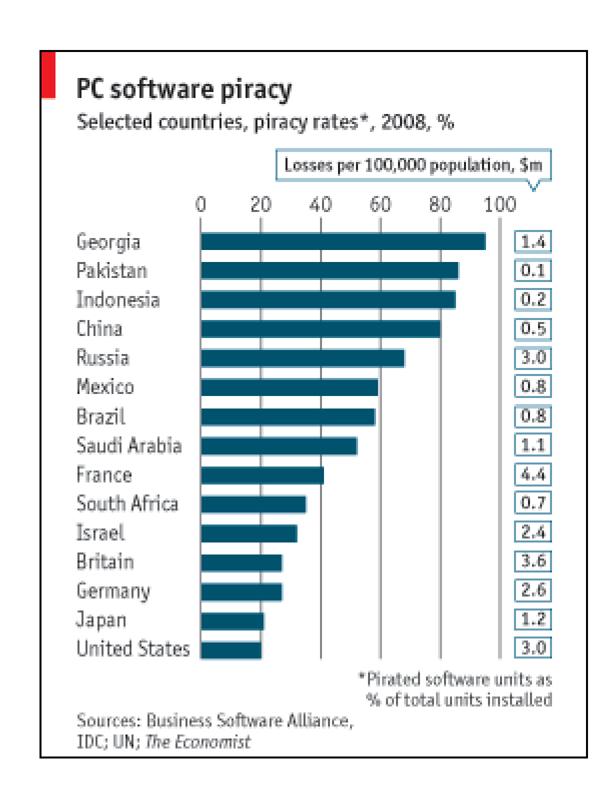
Markets

	Index May 13th	% change on one week	% change on Dec 31st 2008 in local currency	% change on Dec 31st 2008 in $ terms
United States (DJIA)	8,284.9	-2.7	-5.6	-5.6
United States (S&P 500)	883.9	-3.9	-2.1	-2.1
United States (NAScomp)	1,664.2	-5.4	+5.5	+5.5
Japan (Nikkei 225)	9,340.5	+4.0	+5.4	-0.5
Japan (Topix)	888.8	+4.9	+3.4	-2.4
China (SSEA)	2,796.4	+2.8	+46.3	+46.3
China (SSEB, $ terms)	170.0	+0.9	+53.3	+53.3
Britain (FTSE 100)	4,331.4	-1.5	-2.3	+3.0
Canada (S&P TSX)	9,709.5	-4.3	+8.0	+14.3
Euro area (FTSE Euro 100)	727.6	-3.5	-2.5	-4.6
Euro area (DJ STOXX 50)	2,357.3	-3.3	-3.7	-5.8
Austria (ATX)	1,943.5	-3.7	+11.0	+8.6
Belgium (Bel 20)	2,016.4	-0.4	+5.6	+3.4
France (CAC 40)	3,152.9	-4.0	-2.0	-4.1
Germany (DAX)*	4,727.6	-3.1	-1.7	-3.8
Greece (Athex Comp)	2,136.5	-2.5	+19.6	+17.0
Italy (S&P/MIB)	19,381.0	-3.6	-0.4	-2.5
Netherlands (AEX)	250.2	-2.0	+1.7	-0.4
Spain (Madrid SE)	932.7	-2.5	-4.4	-6.5
Czech Republic (PX)	902.5	-5.2	+5.2	+2.8
Denmark (OMXCB)	267.2	-2.3	+18.1	+15.5
Hungary (BUX)	13,592.9	-1.6	+11.0	+1.8
Norway (OSEAX)	322.2	+2.2	+19.2	+28.2
Poland (WIG)	29,495.2	-1.3	+8.3	-1.8
Russia (RTS, $ terms)	947.5	+5.6	+57.3	+50.0
Sweden (OMXS30)†	748.1	-6.4	+12.9	+13.4
Switzerland (SMI)	5,277.4	-0.8	-4.6	-8.3
Turkey (ISE)	32,828.9	-2.6	+22.2	+20.1
Australia (All Ord.)	3,842.5	+0.1	+5.0	+12.1
Hong Kong (Hang Seng)	17,059.6	+1.3	+18.6	+18.6
India (BSE)	12,019.7	+0.6	+24.6	+22.1
Indonesia (JSX)	1,851.3	+2.9	+36.6	+44.0
Malaysia (KLSE)	1,022.8	-0.1	+16.7	+14.5
Pakistan (KSE)	7,242.6	+0.6	+23.5	+20.9
Singapore (STI)	2,185.3	+0.3	+24.1	+22.1
South Korea (KOSPI)	1,414.5	+1.5	+25.8	+27.3
Taiwan (TWI)	6,485.1	-1.2	+41.3	+41.0
Thailand (SET)	552.7	+5.7	+22.8	+23.7
Argentina (MERV)	1,461.2	+3.6	+35.3	+25.5
Brazil (BVSP)	48,679.0	-5.5	+29.6	+43.9
Chile (IGPA)	13,736.9	+3.1	+21.3	+35.3
Colombia (IGBC)	8,907.2	+3.9	+17.8	+17.2
Mexico (IPC)	23,155.0	-3.1	+3.5	+7.4
Venezuela (IBC)	44,033.8	nil	+25.5	+35.1
Egypt (Case 30)	5,868.7	+10.0	+27.7	+25.3
Israel (TA-100)	752.5	-2.1	+33.4	+22.1
Saudi Arabia (Tadawul)	6,044.8	+4.2	+25.9	+26.0
South Africa (JSE AS)	21,289.7	-2.3	-1.0	+7.5
Europe (FTSEurofirst 300)	831.7	-3.1	nil	-2.2
World, dev'd (MSCI)	919.7	-1.6	-0.1	-0.1
Emerging markets (MSCI)	709.9	-0.3	+25.2	+25.2
World, all (MSCI)	233.0	-1.5	+2.3	+2.3
World bonds (Citigroup)	784.9	+1.6	-3.1	-3.1
EMBI+ (JPMorgan)	430.4	-1.0	+9.9	+9.9
Hedge funds (HFRX)§	1,059.7	+0.9	+3.8	+3.8
Volatility, US (VIX)	33.7	32.5	40.0	(levels)
CDSs, Eur (iTRAXX)‡	155.7	+6.4	-23.0	-24.6
CDSs, N Am (CDX)‡	204.5	+2.0	-12.4	-12.4
Carbon trading (EU ETS) €	14.7	+1.0	-8.7	-10.6

*Total return index. †New series. ‡Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac. §May 12th

PC software piracy

May 14th 2009
From The Economist print edition



The share of software on personal computers that is pirated rose to 41% last year, according to a report by the Business Software Alliance, a trade group, and ICD, a market-research firm. A further 44% is paid for. The rest is free or open-source. Piracy rates are falling in half of all countries and stable in another third. But in countries where sales of PCs are growing fastest, the piracy rate is high. The worst offender is Georgia, where 95% of all software is unlicensed. The rate is lowest in America but even there, as much as a fifth of software is pirated. In rich western Europe, around a third of all software is unlicensed. In the big emerging markets, such as China, India and Russia, software piracy has dropped sharply in recent years.